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S. HRG. 104–164

THE MEXICAN PESO CRISIS

[HEA]RINGS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

ON

THE MEXICAN PESO CRISIS AND THE ADMINISTRATION'S PROPOSED LOAN GUARANTEE PACKAGE TO MEXICO

JANUARY 31, MARCH 9, MARCH 10, MAY 24, AND JULY 14, 1995

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

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THE MEXICAN PESO CRISIS

TUESDAY, JANUARY 31, 1995

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:05 a.m., in room SD–106 of the Dirksen Senate Office Building, Senator Alfonse M. D'Amato (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN ALFONSE M. D'AMATO

The CHAIRMAN. The Committee will come to order. I welcome our distinguished witnesses here today. This hearing is on the Mexican peso crisis and the Administration's proposed $40 billion loan guarantee program for Mexico.

My opening remarks will be short and I hope that we can limit our opening remarks so we can hear from our witnesses.

I have a longer statement which I will be placing in the record.

Never before has a President taken the extraordinary step of asking Congress to approve a $40 billion loan guarantee. This is four times the size of the loan guarantee that we approved for Israel and 25 times the size of the Chrysler and New York City loan guarantees.

The Administration has painted a doomsday scenario to justify this guarantee. Congress has a responsibility to review this matter carefully.

I have some very grave reservations about this proposal. I have four basic questions.

First: How did we get into this crisis?

The Administration now claims that it was taken by surprise when Mexico devalued the peso on December 20, 1994, and set off the present crisis, but the signs of serious trouble in Mexico were clearly present months ago.

Who in the Administration was watching Mexico? What did the Administration know about Mexico and when did it know it? Why didn't the Administration raise a red flag before December 20, 1994?

What role did the Administration's inaction or silence play in bringing about this crisis? Did the Administration advise Mexico to devalue the peso?

The second question is: Will $40 billion in loan guarantees solve the crisis?

The cure for Mexico, it seems, must take place in Mexico City. Mexico must adopt a tight monetary policy, privatize its industries, and reform its political system.

I'm concerned that $40 billion in loan guarantees will draw the United States into a more intrusive relationship with Mexico. We risk inflaming anti-American feelings in Mexico.

Third: Why should American taxpayers bail out those who speculated in risky Mexican securities?

These people gambled in the hopes of big profits and now they have to live with the consequences. That is the capitalist system.

What if another country has trouble? Can we afford to do the same?

Fourth: What is the risk that American taxpayers will have to pick up the tab if Mexico defaults on this guaranteed debt?

The Administration assumes that Mexico will pay off the debt, but United States banks were left holding the bag in 1982 when Mexico could not make good on its debts. The Administration has asked American taxpayers to guarantee $40 billion in Mexican debt with a maturity of up to 10 years. Once the President has issued these guarantees, what leverage will the United States have to make sure that Mexico lives up to its promises?

The fact of the matter is that these guarantees expire over 18 months, but the maturity of the debt is over a 10-year period of time.

Before putting American taxpayers on the line for $40 billion, I believe the Administration must make a far stronger case than it has so far. We must consider alternatives. We must protect the American taxpayers.

The present plan, I believe, has many deficiencies and is inadequate. That does not mean that we should turn our back on the crisis, but it does mean that we have an obligation to make sure that the plan can achieve its purposes and also guarantee that the American taxpayer is not left with a $40 billion hole.

We'll take it in order, starting with Senator Gramm, and go right around. I hope our colleagues—I will tell you that we received a call this morning from the Administration regarding whether we would ask them to testify—will be available because it seems they may be working on another plan. I think, in any event, they have an obligation to speak to us about their present plan.

Senator Gramm.

OPENING STATEMENT OF SENATOR PHIL GRAMM

Senator GRAMM. Mr. Chairman, first of all, I certainly hope that Secretary Rubin is going to be here. I think our number one problem is we don't know what the Administration's plan is. I have seen proposals that are floating around committees, but I think it's time for the President of the United States to exert some leadership here and tell us exactly how he intends to solve this problem.

You can look to our left, here in this room, at the empty chairs and see that the President is short of hands on his side of the aisle in terms of people who are willing to get out front and take a position with the President on this issue.

The President does not have to waste any time convincing me that there's a crisis. I hear over and over and over again that there is a financial crisis in Mexico, that we're going to be affected, and that we have 700,000 jobs tied directly to exports to Mexico. My

guess is we have three times that many jobs tied indirectly. I don't need to hear about the crisis. I'm convinced that there's a crisis.

What I am not convinced of is that the President has any coherent plan to deal with this problem. I suggest, since there is a general consensus that there is a problem, our focus of attention should be on the solution.

If people are going to ask us to guarantee a $40 billion loan, then we have an obligation to ask them, what caused the problem in the first place? The Mexican economy was brimming with liquidity at the beginning of 1994. What happened?

If you think of the Mexican economy as a bucket, it was full at the beginning of 1994. It is empty today. The President acts as if that was some kind of accident, that all we have to do is pour some of our water, our money, into this bucket, and everything will be fine.

I'd like to identify the holes. I'd like to be certain that those holes are fixed before we start guaranteeing $40 billion of loans with $40 billion that we don't have.

Second, I submit that we focus in on the question that is before us. I think we are wasting our time and our energy to be talking about conditionality on anything other than the ability of Mexico to assure that these loan guarantees will not be called. We should expect Mexico to be a good neighbor. We should expect Mexico to help us with illegal immigration and drugs. I think our focus here ought to be the kind of focus that a country banker would have.

We have one person in the audience who knows what a billion dollars is. None of the rest of us has the foggiest idea.

[Laughter.]

I know what $1,000 is, and I know if I went to a country banker in Texas and I wanted to borrow $40,000, that banker would ask me, "What is your plan? How are you going to use the $40,000 in a way that is productive enough that you'll be able to pay back the principal and the interest? What kind of collateral do you have if your plans don't work out?"

Now, Mr. Chairman, when we're talking about $40 billion, should we be less diligent than any country banker in America would be in talking about $40,000?

I think the answer is no.

I think it's time for the Administration to provide some leadership. What we have seen to this point is simply a dumping of this problem at Congress' feet. We have 10 or 15 people running around negotiating, often with groups that have conflicting views.

I don't see a coherent plan from the Administration. I'm willing to say, right here today, if they don't come up with a workable plan and come up with it soon, Congress is going to reject this loan guarantee. I think if the Administration is going to lead, they're running out of time.

The CHAIRMAN. Senator Shelby.

OPENING COMMENTS OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman.

Mr. Chairman, I have a written statement. For time's sake, I'd like for it to be made part of the record, and I have a few observations after that.

The CHAIRMAN. All right.

Senator SHELBY. What are we facing here today? I think that's the real question.

Is this a bailout of some bankers in the United States, some investors in the United States, or other parts of the world?

Is it just a Band-aid approach to a real crisis in Mexico? How do we do it?

We're going to hear testimony from someone I have a lot of confidence in, and that's William Seidman, who was Chairman of the Federal Deposit Insurance Corporation for a long time. He's seen a lot of this.

We're going to have testimony here this morning from Ross Perot, as Senator Gramm says, who knows what a billion dollars is.

I don't know if he's got $40 billion, but I'll tell you what. I'd be surprised if he would invest his money or anybody's money like the proposal is going to invest the taxpayers' money of the United States of America.

I think these are real questions that we have to ask.

I want to pose one other question. Seven or 8 years ago, when we had the thrift bailout, right before this same Banking Committee, I posed the question to Chairman Greenspan and Secretary Brady at that time on their first proposal, when they said, "We need $50 billion for the thrifts' bailout in the United States."

I asked, "Is that enough? Will this be the only time you come to the table?" "Absolutely right," was the answer. "Never will we be back."

Eighteen months or so later, they were back at the table. I read the transcript to them of the first question that I asked and voted against it each time thereafter.

If we were to be foolish enough—I hope we won't—to just give a guarantee of $40 billion, with no security to speak of, would this be the end of it?

A lot of people say, no, it won't be the end. It's the beginning of it.

Wouldn't Mexico be better off in the long run if they quit printing money and went through some austerity program that would shore up their finances, that would bring back confidence in what they're doing in Mexico, and allow capital to flow in?

I'm afraid this is just a temporary solution. It might not even be temporary if we don't hear from the Administration. I don't see any of them in the audience yet. We hope they'll show up later.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Boxer.

OPENING STATEMENT OF SENATOR BARBARA BOXER

Senator BOXER. Thank you very much, Mr. Chairman.

I think it's more important than a blame game here, to get our questions answered. I, frankly, haven't had my questions answered.

On the very day this was announced, I wrote a letter on January 13, 1995, with Congressman Steve Horn from California, asking that the Administration be able to get a very specific commitment from Mexico on the border patrol issue.

I don't think it's any great secret that people know the impact on my home State of California of illegal immigration.

Now, it seems to me, when we are signing on the dotted line for $40 billion or whatever the amount, we should insist that there be a greater commitment than there has been.

When I asked the Administration about that, they said they were going to work hard to see that that would happen, that, in fact, there would be a commitment from the Mexican government to help us control the border.

Then we see this headline. This is The New York Times, January 27, 1995—"Mexicans Deny They Would Order Border Crackdown in Return for United States Loan Guarantees."

It doesn't seem as if that particular condition that Congressman Horn and I were talking about is even close to being met.

We get 40 percent of the total illegal immigrant population in our State. I want to point out that the Federal Government spends about $460 million annually on the U.S. border patrol, $460 million annually, and we are being asked to sign a $40 billion loan guarantee.

It would be a very small part of that guarantee, it seems to me, if the Mexican government would commit to help us with those borders. We cannot handle this problem. In the unfunded mandates bill, I had an amendment that would have begun the reimbursement to California, Texas, and other States of those costs. Unfortunately, my amendment garnered just 40 votes.

I look at illegal immigration as one of the biggest unfunded mandates in my home State. If we couldn't address it in the unfunded mandates bill, we darn better well address it if we move forward with this. I am still looking for answers on that issue.

Mr. Chairman, I only have another minute to speak because I know you don't want us to make long speeches and I will not do that.

I want you to know, Mr. Chairman, I was stunned to read, and perhaps will find out if it is true today, that the buyers of some of these notes, that we will be actually bailing out, receive between 15 and 50 percent interest on those notes.

I have to ask a rhetorical question here, and perhaps it is following on some of my colleagues, that one should assume, and we certainly learned this in Orange County, California, where there is no bailout being asked for or thought of in any way, shape, or form, that when you earn that kind of a return, 15 percent, when the going rate is 6 percent, and up to 50 percent, don't you understand the risk you are taking? What kind of signal is it, I ask, rhetorically, that we are going to send if we step in and bail out that kind of risky investment?

I think it's a very bad signal to send.

Obviously, I have some very serious, serious questions about this. I'm a little bit, shall I say, uneasy about this.

I look forward to this hearing, perhaps to clarify some of my thoughts and answer some of my questions.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Bond.

OPENING STATEMENT OF SENATOR CHRISTOPHER S. BOND

Senator BOND. Thank you very much, Mr. Chairman.

I'm very pleased that you're holding this hearing today because over the last 3 weeks, we've heard a lot of charges, a lot of promises. We have a very heavy duty to sort through that jumble and determine what really is in the best interests of the people of the United States. I hope today's hearing, the witnesses before us, and the questions and answers will shed some light on it.

There is no question, however, that Mexico and the Mexican economy are very closely tied to our interests. We have a great interest in relations to a neighbor that shares a 2,000-mile border with us. It's been peaceful for more than a century. It is a benefit that few Americans truly appreciate.

It should not be underestimated. It's certainly in our interest to see that that border remains peaceful for the long term, and there's no question that we have an interest in seeing a stable economy, a growing and prosperous economy, in our large neighbor to the south.

On the other hand, no one can deny that our economic security is important. We cannot be asked or expected to vote for these guarantees, or any other plan which might be presented to us, without a clear understanding of the importance to our security, the terms of the plan, and the assurance that the plan actually will work.

The proposal which the Administration has floated is not one that we can undertake lightly. I have quite a few questions about it that I will have to have answered before I could consider voting for a plan.

I would reiterate what has already been said. If it is truly in our interest, if we must take some steps to rescue the peso, whatever those steps may be, and if we are putting our necks on the line to rescue a neighbor in great economic distress, then I think, as many important issues as there may be, as many other considerations as we have, we ought to be making a hard-headed financial judgment as to what is necessary to stop the bleeding.

You may want to give the patient a haircut, but the haircut is not a priority when the patient is bleeding to death.

If that is, in fact, the situation that we find and we are expected to stop the bleeding, let's forget about the haircut until the patient is healthy.

I am hopeful that the witnesses before us today will be able to add to our understanding as to what has happened in Mexico, its implications for the United States and the world economy, and the impact that the various United States responses might have in addressing the crisis.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Murray.

OPENING STATEMENT OF SENATOR PATTY MURRAY

Senator MURRAY. Thank you, Mr. Chairman. I won't make a long opening statement either, but I concur with the questions that my colleague from California has raised.

Since we first heard about this issue, I think many of us have asked a lot of questions and I hope some of them get answered today.

I spent my time on the phone yesterday talking to the apple-growers in my State, the wheat-growers, and people who depend a lot on exporting our products to Mexico. I have to tell you, I was very concerned about their lack of understanding, despite the fact that we depend heavily on trade to Mexico from my State, about this issue and the serious questions they raised.

I think they've heard the sky is falling before and they are becoming more and more skeptical.

We need to be assured that, indeed, this is not only the sky is falling, but that what we are putting together is going to make a difference.

I guess I'm skeptical because I have a teen-age son and if he came to me and asked me to co-sign a loan for a car, I would ask a lot of serious questions.

I assume we will do that as well today and I hope we get the answers to them.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Faircloth.

OPENING COMMENTS OF SENATOR LAUCH FAIRCLOTH

Senator FAIRCLOTH. Thank you, Mr. Chairman. Thank you for holding the hearings. We certainly need to have them.

I have a statement which I will put in the record, but a few observations have occurred. As I hear what we're saying this morning, the first question I'd like to ask is who do they owe the money to?

As was mentioned earlier, when you're getting from 19.8 or whatever percent interest, don't you expect the risk to be high? Certainly, in this case, it was.

I am not even in doubt, I am very much opposed to it. My question is, really, what did the Mexicans do to get in this problem that we aren't doing ourselves?

I think, maybe, this is really what we ought to be looking at. They've got a huge trade deficit. So do we. Domestic spending is out of control. So is ours. The debt is increasing at an astronomical rate, with out-of-control borrowing, and so is ours.

I think we should be getting a lesson here and the lesson should be are we headed behind Mexico and who bails us out.

We have $51 billion in loan guarantees for other countries around the world. This would almost double it.

We talk about putting fiscal constraints on Mexico, we, this Congress, who for 35 years has been spending money like drunken sailors, we are going to buckle down and put constraints on Mexico. No wonder they laughed at us and said that the Mexican congress would have to approve the loan agreement before they would accept it.

Frankly, I think it's time we worried about our own condition and put Mexico second.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Faircloth.

Our first panel——

Senator GRAMM. Mr. Chairman, would you yield for just one minute?

The CHAIRMAN. Yes.

Senator GRAMM. The only thing different between Mexico and the United States, in terms of things you outlined, is the gentleman sitting on the front row here, Federal Reserve Chairman, Alan Greenspan, who heads an independent monetary authority.

The one thing we are not doing that the Mexican authorities have done is that we are not letting our money supply get out of control. The one area where we're different is the one area where neither Congress, nor the President, has control. We have an independent monetary authority. If not, we would be in exactly the same situation today as Mexico finds itself.

Senator FAIRCLOTH. Mr. Greenspan, do you have a brother that could go to Mexico?

[Laughter.]

Senator BOXER. Mr. Chairman?

The CHAIRMAN. Yes.

Senator BOXER. May I speak out of order for 30 seconds?

The CHAIRMAN. Yes.

Senator BOXER. Thank you. I think there are huge differences between the United States and Mexico, not the least of which is the greatest Constitution on earth, a stable Government, and a very healthy two-party system.

The CHAIRMAN. OK. With that, noting that distinction, we'll call our first panelist, Senator Hank Brown from Colorado.

Senator Brown, we welcome you here today. You have been studying this area and we're very pleased with your participation.

OPENING STATEMENT OF HANK BROWN U.S. SENATOR FROM THE STATE OF COLORADO

Senator BROWN. Thank you, Mr. Chairman. I appreciate the privilege of speaking to this distinguished Committee.

I will not trouble you long, but I wanted to share just one thought with you that I hope may have meaning for you as it has for me.

A lot of things have been brought up as the reasons why we ought to get into this deal. Some have talked about illegal immigration. The reality is this proposal doesn't have any funds for controlling illegal immigration and that's really not the basic reason why we're interested in it.

Some have said we're interested in it because sales to Mexico might drop. The truth is sales to someone who can't really pay aren't legitimate sales to begin with.

My sense of the reason we're interested in this as a country is that we like the Mexicans. We want to be good neighbors and we want to help them out. It's in that sense, I hope, that this Congress will pause and think about this before we do it.

If our real purpose, as I believe it is, is to be a good neighbor and to help out, let's ask ourselves what happens to that good neighbor relationship, that friendship we prize so highly, that closeness we want to develop, what happens to that relationship we want to cherish and expand if we become Mexico's banker?

Bankers have a tough job. They impose discipline. Sometimes they foreclose. Sometimes they say no. Sometimes the conditions they set are painful.

Imagine the feelings of Mexican people and the Mexican congress if we as a Nation dictate terms and conditions to them. Ask yourself how you'd respond if Mexico dictated terms and conditions to us.

In 1964, my grandfather had a banker call a loan on him. He was in the cattle business. It's a tough business. It's volatile. The market had dropped precipitously.

He was a little elderly. At that time, he was in his 80's, his early 80's. The banker, I guess, was afraid he wouldn't get his money back, so he sold all of his cattle out of his feedlot and forced him to sell his lot. When they finished, he had enough to pay his debts and a little left over, but that was about it. His lifetime business was gone.

I want to promise you, he never forgot how that banker treated him. Not till the day he died. Neither did my grandmother, his two daughters, his grandchildren and, I guarantee you, my grandchildren will remember how that banker treated him.

Think about what kind of relationship we will build with Mexico if we become their bankers, if we become the ones who impose discipline on them.

Mr. Chairman, my sense is that it's a great mistake for this country to take on that role, that it's a great mistake for us to put ourselves in a position of dictating terms and conditions which are essential for anyone who lends money, and that we're far better off to act through the International Monetary Fund.

I'm advised that, as of today, they have $68 billion in lendable reserves. In addition, they have $40 billion, or a little more than that, in gold and they have a line of credit for $24 billion in addition to that. They're in the business of handling these kinds of crises.

For America to become the banker for Mexico, I think, would sour a relationship that all of us want to see improved and enhanced.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Brown, I want to thank you because I think you've made a good point, and raised a concern that I have. We have not even looked into the question of whether we will be able to impose and enforce conditions that are reasonable but, where sovereignty exists, it becomes politically impossible to carry out one or the other. I think you have gone right to the heart of one of the most serious problems—the United States being viewed as big brother, making impositions that someone will promise to carry out, but won't have the political will or the ability to do so.

I don't know if anyone wants to ask questions or make observations.

Yes, Senator Boxer.

Senator BOXER. I have one question for the Senator. I thought your testimony was compelling and your analysis to a family situation very meaningful. I would agree, if there was another way to go, that IMF certainly would be the way to go, if we could work

that out. I do, however, want to raise another point with you in the interest of history.

I know you're one of the strongest supporters of Israel in Congress. As a matter of fact, I know that Israel has practically unified support in Congress.

Did you feel this way when they asked for a $10 billion loan guarantee?

Senator BROWN. I did not. I supported that loan guarantee and I did it because I thought there was a very realistic possibility that that money would be paid back. To ensure the safety of the taxpayers' money, it seemed to me that it was not necessary for us to engage in the kind of conditions that would be offensive and sour our relationship.

I might mention, if you'd allow me, that my understanding is that the IMF has stepped forward with a $7½ billion package.

Senator BOXER. Yes, I know that.

Senator BROWN. Obviously, much more is needed.

Senator BOXER. I know. I would just say to you that we did put conditions on Israel that were pretty stringent. That's why I'm pursuing this. We did say she couldn't build in the occupied territories and she couldn't use the funds for the military.

I just make that point on the issue of friendship. It did not sour our friendship with Israel. You may very well be right in the situation of Mexico. My concern, which is illegal immigration, is a very tough, tough issue. They haven't cooperated with us in the past and it could be, if we pushed too hard, problems for the Government.

You make a good point there, but I did want to say that we did have a successful experience with Israel and the loan guarantees.

Senator BROWN. I guess what gave me comfort in that is the economic record of Israel and, in particular, the continuing, long-lasting obligation that the United States commitment has given to Israel. To some extent, it was the self-funding.

The CHAIRMAN. Any other questions?

[No response.]

Senator Brown, we thank you so very, very much for your participation.

Senator BROWN. Thank you, Mr. Chairman.

The CHAIRMAN. I was just handed an AP release dated for today at 10:25. It came out as being "urgent." It says, "Clinton Pulls Plug on Mexico Aid Package."

'President Clinton today abandoned his effort to win approval of a $40 billion aid package for Mexico after congressional leaders told him the chances for winning approval were slim. Instead, Clinton will use his Executive Authority as President to help stabilize shaky Mexican finances,' said White House Spokesman Mike McCurry. McCurry did not elaborate what Clinton planned to do, but said the President 'would outline the steps later today in a speech to the Nation's governors.'

McCurry said the congressional leaders told Clinton that winning approval for the package of loan guarantees 'would be enormously difficult.'

That came out "urgent" today at 10:25, so, literally, less than 10 minutes ago.

Since the Treasury has apparently abandoned their loan guarantee, I will ask, because I still am interested in hearing from Mr. Seidman, Ross Perot, and our Chairman, Alan Greenspan, who

have taken the time to be here, if they would like to share with us their thoughts?

I'll be bound by your feeling on this. If you feel it's appropriate to speak at this time, Alan, why don't you come up here?

First of all, let me thank you for being here to testify because this is a terribly important matter and a very difficult situation. I think the question is: Is there a methodology by which we can help ease this crisis? I think Senator Gramm said it best. We don't need people telling us it is a crisis. It is a crisis. The house is burning. We understand that.

How can we best put out that fire and, by the same token, see to it that we're not engulfed ourselves? I think that's what it comes down to.

Senator GRAMM. Mr. Chairman, may I just pose one question?

It's my understanding that one of the options the President is going to be looking at is using resources from the Exchange Stabilization Fund. I understand that we may have as much as $20 billion available in the Exchange Stabilization Fund.

It would be helpful to us, in case that is correct, if you could at least brief us on that and how it would work, along with any other comments you may have.

OPENING STATEMENT OF ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, WASHINGTON, DC

Mr. GREENSPAN. Senator, ordinarily, I would be delighted to do so but I think, considering the fact that there's been no official announcement of any details, it would be inappropriate for me to get involved in it.

Mr. Chairman, I'm not sure there's much I can add to what you have just stated. Certainly, if you would like to pose questions to me on this general issue, I must say, I don't disagree with the way you formulated the nature of the problem that exists. I obviously feel quite restricted in being able to respond in any useful way to questions at this time. I would suspect that, in 24 hours, as you have stated it, there will be a presentation by the President——

The CHAIRMAN. I think it's going to be later today, again, from what the release indicated.

I note Secretary Rubin is not here. Is there an official here from Treasury?

Mr. GREENSPAN. I believe there is. I think, as I understand it, Jeff Shafer was coming down.

The CHAIRMAN. Why don't you come up and, instead of making your presentation, I'm going to ask the Members of the Committee if they have any questions for you.

I think people will find it disquieting to address the plan, now that the plan has been dropped.

I must tell you, I'd rather see that plan put aside and work on a constructive alternative, if there is one.

Yes, Senator Shelby.

Senator SHELBY. Mr. Chairman, I would like to ask Chairman Greenspan and also the gentleman from Treasury, what are——

Mr. GREENSPAN. I might say that this is Jeffrey Shafer, who is Assistant Secretary of the Treasury for International Affairs.

Senator SHELBY. Thank you for being with us.

Mr. GREENSPAN. He is a well-regarded international economist, I might say.

Senator SHELBY. We're glad to have you here, especially after the AP bulletin at 10:25.

What are the options, the latitude that exists with the President to deal with this crisis, short of congressional help?

Mr. Secretary?

OPENING STATEMENT OF JEFFREY SHAFER ASSISTANT SECRETARY OF THE TREASURY, INTERNATIONAL AFFAIRS, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. SHAFER. Mr. Chairman, Senators, first of all, please let me express Secretary Rubin's regrets that he was unable to come at this time.

As you know, last night, the Majority Leader and the Speaker notified the President it was their judgment that the legislation the Administration and the bipartisan leadership had been working on could not pass, and recommended a different approach.

This morning, the President and the Secretary met with the leadership. That meeting was concluded just a few minutes ago. Secretary Rubin is working with the President on the details of a new approach.

Because that's being worked on at this moment, I am not in any position to discuss any proposals. I can talk about——

Senator SHELBY. If not a proposal, what's the latitude that the President has? What are some of the options? Not that he would necessarily go that route, but what are some of them?

Mr. SHAFER. I'm not in a position to discuss the various options that might be being discussed at this moment while I'm up here and the people who are considering them are in the White House, Senator.

Senator SHELBY. As the President of the United States, he has certain powers vested in him as the Chief Executive to do these things. That's what I'm talking about.

What are those things that are being considered? I'm not asking what they would be proposing. What are they?

Mr. SHAFER. I don't think I can anticipate a statement that the President may make sometime today or, I'm told, possibly very shortly.

Senator SHELBY. So he'll just be considering every option, possibly, that he can do, short of congressional ratification or legislation. Is that right?

Mr. SHAFER. All of the options that are available.

Senator SHELBY. But you don't want to detail those options.

Mr. SHAFER. That would include the use of Executive Authority.

Senator SHELBY. But you don't want to talk about those options here today.

Mr. SHAFER. I'm not in a position to specify the specific options that are being considered right now.

I should say, in the expectation that the President will make a statement soon, Secretary Rubin will be in a position this afternoon, if that happens, to come and brief Members of the Senate

and the House of Representatives on the details of the course that's chosen.

Senator SHELBY. Chairman Greenspan, do you want to comment on that?

Mr. GREENSPAN. I can't go any further than the Secretary, Senator.

Senator SHELBY. I guess we'll have to wait for the press conference.

The CHAIRMAN. Senator Bond.

Senator BOND. One thing that——

Senator DODD. Mr. Chairman, can I be heard?

The CHAIRMAN. He just wanted to ask a question. I'll come right back to you, Senator.

Senator BOND. One question that perhaps, maybe, you could address, putting aside what the United States might do, as experts in the field of finance and monetary management, what would your best advice be to our friends in Mexico to get their currency under control?

What do they need to do internally, because much of what I think we're going to be talking about revolves around conditions? Could you outline some of those for us, Mr. Chairman?

Mr. GREENSPAN. Senator, the crucial problem that now confronts Mexico is the classic market problem of lack of confidence. This, in turn, requires that there be a very firm monetary policy to endeavor to support the currency.

Ultimately, confidence in one's currency is an issue which pervades all aspects of an economy. If you do not have a very solid anchor for one's currency, both domestically and internationally, the rest of economic policy is essentially very difficult to implement.

The crucial issue, at this stage, is to restore international confidence in the Mexican peso. There are a lot of ways in which that can be done, but an indispensable way is to make certain that one's monetary policy is consistent with a noninflationary environment.

The CHAIRMAN. Senator Dodd.

OPENING COMMENTS OF SENATOR CHRISTOPHER J. DODD

Senator DODD. Thank you, Mr. Chairman.

Let me just, first of all, review the bidding a little bit on this issue. I regret, personally, that we're unable to respond to the Administration's request to put together a legislative package to deal with this issue.

Now, there are some, I know, who don't believe that this is a crisis situation. If you don't reach that threshold issue, then I suppose doing nothing is an acceptable solution. I happen to subscribe to the view that this is a serious situation that demands serious, calm, cool thought as to how to resolve it.

I'm disappointed that, apparently, we're not going to be involved in that solution from the legislative side, but I commend the President for taking the unilateral action to act on this issue because my concern would be that, while points may be scored about how the matter was handled, not to deal with the issue, to me, would be a far more serious result in light of the consequences of not restoring confidence, as the Chairman has just pointed out, in the Mexican peso.

This is not just a Mexican problem. For those who have looked at this issue, this is an issue that goes far beyond the borders of Mexico and has profound implications for the United States, profound implications for this hemisphere.

I'm disappointed that we were not able to follow the leadership here. I commend Senator Dole and Speaker Gingrich for getting behind the President early on and trying to move this matter. I'm disappointed that we, as a body, were not able to come together around a solution sooner so that we would be involved in this matter.

I commend the Administration for coming up here early. We, as a body, constantly over the years, have been critical of Administrations that don't come to Congress earlier on to seek our involvement, our advice, and our suggestions. This Administration did that. It went through the proper steps of trying to involve the leadership. Having done that, we, in my view, dropped the ball, in a sense, by not responding to that call.

I commend President Clinton for moving in this direction. I gather that later today, we'll get some spelling-out of this, but not to act at all would be stepping back from Presidential leadership.

You can't have it both ways here. You can't, on the one hand, be insisting that the leader of this country act as the leader of the world, or one of the great leaders of the world, and simultaneously undermine that leadership, in a sense.

I commend the Administration for the direction they're moving in. Obviously, until this is spelled out, it's a little difficult to have a hearing on exactly what it involves. As the Chairman has just pointed out, this is a very delicate moment. It is a lack of confidence. How we react, how we respond in this hearing and in the next day or so, can have a lot to do with whether or not this succeeds. I would urge my colleagues to restrain the temptation to take advantage of a political situation here. The temptation——

The CHAIRMAN. Senator?

Senator DODD. Let me finish.

The CHAIRMAN. I don't believe that's necessary.

Senator DODD. Senator, I believe the time is mine. I do believe the time is mine.

The CHAIRMAN. As Chairman, I will say that I think you're out of line.

Senator DODD. I'm not out of line.

The CHAIRMAN. I think you are. I think you're wearing a different hat, and I think you'd better save that hat for another time.

Senator DODD. I think the rhetoric——

The CHAIRMAN. I'll just make an observation. Where do you get the nerve to talk about restraining rhetoric?

You're the first person to enter politics into this.

Senator DODD. Mr. Chairman——

The CHAIRMAN. Let the record show very clearly that everyone here is looking for alternatives.

Senator DODD. Mr. Chairman, let me just point out that the mere fact that we're having this hearing, despite the request to postpone this hearing——

The CHAIRMAN. That is a lot of nonsense.

Senator DODD. Let me just be heard, Mr. Chairman. Can I be heard?

The CHAIRMAN. Yes, you will, and we'll respond.

Senator DODD. I think even holding a hearing at this particular juncture—we could wait a few hours. It's not going to kill us in Congress to wait a few hours and to see what this is about before we go charging off here.

That's my point.

The President has said he's now not going to come to Congress. He's going to use his power as Chief Executive to move. Let's hear what that involves. Let's then sit back and have a hearing on what it involves.

That's my point.

The CHAIRMAN. Let me say, until 10:25 today, Senator Dodd, there was no request to postpone this hearing. The Administration had ample time to do so. Last week, we told them we were going to have the hearing. We submitted 19 questions to them.

I'd suggest that you now wear your political hat as DNC Chairman. Nobody here has raised the issue of politics, other than yourself. I think you do a great disservice.

As a matter of fact, as Chairman of this Committee——

Senator DODD. Mr. Chairman, there was no request not to have this hearing this morning?

The CHAIRMAN. —I have indicated to the Chairman that I did not know whether he thought it was even appropriate or necessary, after we learned about this, to make a statement. We then asked whether there were any questions regarding the broader issue.

Senator DODD. Mr. Chairman, may I inquire, was there a request not to hold this hearing today?

The CHAIRMAN. The Administration did not make such a request. I learned for the first time, at 10:25, that the Administration did not intend to go forward with its proposal.

Senator DODD. And no request was made not to have this hearing.

The CHAIRMAN. I have not received a request not to go forward.

Now, the fact of the matter is, I think we should remain calm and I don't think we should politicize this, nor has anyone attempted to do so. That's precisely why I raised the issue. I don't believe we should attempt to politicize this. Certainly, I haven't done so.

Let me say that the President is going to make a speech at 11 a.m. I see that Mr. Seidman is here. I don't know whether it's appropriate for him to speak, at this time, about his observations, or for Ross Perot to speak about his observations, with respect to the plan.

I don't know if, after just listening to the President, it's appropriate for us to attempt to have a hearing on something that he's just laying out. That would be very difficult, and I wouldn't want to second-guess him on that basis.

I will ask our panelists, since they have taken their time to come, whether they wish to address the issue in a broader sense—maybe Mr. Seidman—and whether they have suggestions as to how to go forward, so that they are given the opportunity to make known their views?

Senator BOXER. Mr. Chairman?

The CHAIRMAN. Yes.

Senator BOXER. Mr. Chairman, might I just ask a couple of questions?

The CHAIRMAN. Certainly. I think, since our witnesses are here, any Members who wish to address questions should be given the opportunity to do so.

Senator BOXER. Mr. Chairman, thank you. I feel very bad about the exchange that just took place.

If I might just say, as I understand it, Senator Gramm criticized the President and made the point that, at the time he was speaking, no Democrats were present here because we didn't want to defend this plan.

To say that one of the Members here injected politics, we need to be honest. Politics is a part of what we do. I just would hope that we wouldn't be interrupted in the middle and if we disagree with each other, we could wait until a person finishes.

That would just be an observation.

I wanted to ask Mr. Greenspan what I think is an important question. That is, his decisions and the Fed's decisions on interest rates are going to really impact what happens in Mexico. I know it's a very delicate matter, but let me ask you a question in this way so that it is hypothetical.

If interest rates here go up, say, a half-percent, what impact does that have on Mexico's interest rates, that they're going to have to draw money into their country? As they repay these old notes to issue new notes, what impact, if you could quantify it, does every, say, half-percent of interest rate rise here have on Mexico?

Mr. GREENSPAN. Senator, let me merely rephrase your question in an historical context.

Senator BOXER. OK.

Mr. GREENSPAN. I think it is reasonable to say that the increases in American interest rates, dollar-denominated interest rates, since almost 12 months ago, have had some effect on the issue of capital flows into Mexico.

Our best judgment, however, is that it's a very small effect. One need only look at the changes in interest rates, both dollar-denominated or, more importantly, peso-denominated interest rates in Mexico, and their orders of magnitude to realize that the actual changes that have occurred in the United States are a very small fraction of the changes that have occurred in Mexico.

On top of that, there are numerous other forces that are involved in the Mexican scene.

It is very difficult to try to infer that the interest rate changes that have occurred in the United States, both short-term and long-term, have had a really material effect on Mexico. I think it's a mistake to say that it has zero effect but, I think, as best we can judge, it's really quite marginal.

Senator BOXER. Mr. Chairman, I have one more question, if I might.

The CHAIRMAN. Sure.

Senator BOXER. Thank you very much.

I would ask our friend from the Treasury to explain to me again, because I think I need to understand this better, what can the

President do to handle this matter under his current authorities without coming to Congress?

What can he do? I'm not asking you what will he do, but just what are his parameters? What can he choose from?

Mr. SHAFER. Senator, with the President scheduled to speak on what he will do in about 3 or 4 minutes, I really think it's inappropriate for me to go through the theoretical inventory. I'm not sure I would exhaust it, in any event, legislative and nonlegislative, that the President could make use of. I think we should wait 3 or 4 minutes and see what he's going to do.

Senator BOXER. I just don't accept that. Can you just tell me, what is the biggest—what can he do?

I'm not asking you to tell me what he's going to announce. I just want to know for my own information.

Senator D'Amato has made a good point, that he doesn't think it would probably be useful for us to hold immediate hearings.

You're here to educate us. What is the biggest weapon he has in his arsenal that he could use to help in a situation like this?

Mr. SHAFER. I don't think I'm in a position to enumerate the options that the President considers feasible for him to use, especially in anticipation of a statement that he is about to make.

I'm sorry. I regret that.

Senator BOXER. Mr. Chairman, I find that very strange, but there's nothing I can do.

Senator SHELBY. If the Senator from California would yield, I agree with you. I felt that was strange, too, when we have someone up here from Treasury that could have discussed the options the President had, maybe not the proposals he would make.

Senator BOXER. Just for my own edification would be useful.

Mr. SHAFER. The options, I guess, in a theoretical sense, are really quite broad. I don't know what kind of an inventory one would spell out if one sat down and thought about all of the possible moves, both within his authority and that of encouraging others to act as well. That's why I think we need to see what kind of proposal he makes, which I think will be coming in just a very few minutes.

The CHAIRMAN. Senator Shelby.

Senator SHELBY. Secretary Shafer, have you in your capacity—what is your position in the Treasury Department?

Mr. SHAFER. Senator, I'm the Assistant Secretary for International Affairs.

Senator SHELBY. OK. Have you been in the discussions with the President and the Secretary of the Treasury on future proposals?

Mr. SHAFER. I have not been in the discussions this morning, which followed either with the congressional leadership or the ones that have followed after that.

Senator SHELBY. In other words, you're the Assistant Secretary of Treasury for International Monetary Affairs and you're not having any input into what's happening here?

Is that what you're saying?

Mr. SHAFER. I am here addressing this group, and I cannot be here and, at the same time, have direct input into that process that's taking place in the White House now.

Senator SHELBY. Have you made recommendations to the President regarding this new proposal, whatever it might be? Have you made, yourself, in your capacity as Assistant Secretary of the Treasury for International Affairs, recommendations? This is your bailiwick, is it not?

Mr. SHAFER. It is my bailiwick. I have discussed, going back to the middle of December, on an ongoing basis with my——

Senator SHELBY. Have you made, sir, concrete proposals to the President as an alternative——

Mr. SHAFER. Directly, me? No, sir.

Senator SHELBY. You haven't?

Mr. SHAFER. No, sir.

Senator SHELBY. What have you been doing in your job?

Mr. SHAFER. I have been providing the Secretary of the Treasury, Mr. Rubin, and the Under Secretary, Mr. Summers, and Deputy Secretary, Mr. Newman, with advice and analysis on the course of events.

I have spent a great deal of time, in recent weeks, speaking to the issue of the seriousness of the problems in Mexico and the need for a response, helping to try to generate support for the legislative proposals, and, in fact, working on those legislative proposals with congressional staff.

Senator SHELBY. Sir, in all due respect to you personally, and to your background, if you are not involved in this type of discussion, in-house, dealing with an international crisis, and that's your job, at least part of your job at Treasury, maybe we ought to review whether or not we need that position in Treasury. Obviously, the Administration doesn't think so.

Mr. SHAFER. At this moment, Senator, one needs that position in Treasury, in part, so that——

Senator SHELBY. For what? For what reason?

Mr. SHAFER. —someone can appear before this Committee while others are addressing the issue of exactly what the President should do in a few moments.

[Laughter.]

Senator SHELBY. But your appearance here today hasn't added anything, other than goodwill, I suppose, whatever that is.

Mr. SHAFER. I certainly do want to show goodwill, to express the regrets of the Secretary that he's not able to be here this moment. I'm prepared to speak to the issue——

Senator SHELBY. When are you going to come before us with some substantive proposal? When are you going to do that?

Mr. SHAFER. I would hope as soon as the course is set, and that could be as soon as a few minutes from now.

Senator SHELBY. What enlightenment.

The CHAIRMAN. Senator Moseley-Braun.

OPENING COMMENTS OF SENATOR CAROL MOSELEY-BRAUN

Senator MOSELEY-BRAUN. Thank you very much, Mr. Chairman.

I am sorry I missed the comments earlier regarding the lack of participation. I would have been here, but for the fact that I was at a meeting of the Finance Committee, on which I'm a Member, and we were upstairs discussing savings and investment and the budget.

I thought that was important and since I'm near the end here in the Banking Committee, I tried to juggle my time, and that kept me from being here.

Having walked into this meeting at the time that I did, though, was probably altogether appropriate because, it seems to me, if the President is going to make his announcement shortly, we ought to adjourn and go listen to him to find out what's going on.

Since that's what we're supposed to talk about today, it might be helpful to hear what the President has to say about it.

The CHAIRMAN. Thank you, Senator.

Senator Faircloth.

Senator FAIRCLOTH. Chairman Greenspan, at a previous meeting on this, and I don't even remember where the meeting was, which isn't important, I was impressed with what you said, that these financial crises come on rapidly.

I think that's what you said, that we don't think they're there and they just almost, literally, explode in front of us.

Are there other countries around the world that you would suspect of significant nature that this is a potential to happen in?

Mr. GREENSPAN. Senator, if I knew of any, I obviously would not be able to comment.

Senator FAIRCLOTH. I'm not talking about specific countries.

Mr. GREENSPAN. I do think, as I indicated to you previously, that there is something different in the last 10 or 15 years, which is the extraordinary increase in global finance which has been driven by the dramatic changes in telecommunications and computer-based technologies, which have enabled two things to happen.

One, the proliferation of new financial products which have been very useful in assisting market economies around the world in increasing their standard of living but, also, it has actually acted through competitive forces to break down barriers of international trade and the movement of capital, which has been of general assistance to all participants in the market economies of the world, which is, increasingly, almost everybody.

One looks at North Korea and Cuba as the outliers, but most everyone else is, to a greater or lesser extent, involved in that particular process.

The one aspect of this extraordinarily valuable international market is also that it is very effective in transmitting mistakes of macroeconomic policy of individual nations and transmitting financial crises which, in a past period, would have been contained within a domestic economy. In the current environment, that spills over much more rapidly and in a more unstable fashion than one perceived it in an earlier generation.

I think what we are dealing with is a much higher level of technology and market effectiveness and, therefore, a much greater effectiveness of the transmission of mistakes.

One can best characterize, if one looks at the policies that got Mexico into trouble in this past year, Mexico as an extraordinary case in which we are seeing effects certainly throughout Latin America, but one also senses a spill-over effect because where currencies lack confidence, you find that portfolio capital, meaning the mobile stocks, bonds, and mutual funds, tend to move in when there's seemingly a good opportunity, but very readily move out.

It's that process which is relatively new in the international sphere, especially among so-called developing nations.

Obviously, we've had that in previous periods in the history of the industrial world going back into the 19th century, but it's far more rapid today. The timeframe has very rapidly contracted, so that the adjustment processes are really different.

Back in, say, the 1820's, you could be the owner of a major financial institution in London. The institution could go bankrupt and you wouldn't know about it for 3 weeks. Today, 3 seconds is a longer timeframe than is probably required.

Senator FAIRCLOTH. Thank you.

The CHAIRMAN. Senator Sarbanes.

OPENING COMMENTS OF SENATOR PAUL S. SARBANES

Senator SARBANES. Mr. Chairman, I want to just make a couple of observations before I put a question to Mr. Greenspan.

First of all, Mr. Shafer, I think you should have said that the top echelon of the Treasury, the Secretary, the Deputy Secretary, and the Under Secretary for International Affairs, are all, I take it, at this very moment, working on this problem.

Is that correct?

Mr. SHAFER. That's correct.

Senator SARBANES. So I do not think it is altogether fair to portray you or the Treasury as not intimately involved.

Now, I just want to make this observation. On January 11, 1995, the Chairman of this Committee went to the Floor of the Senate and made a statement that, "We must help the Mexicans stabilize the peso to renegotiate their debt and to develop an economic strategy of long-term investment and growth."

On January 13, 1995, the papers carried a headline—"U.S. Leaders Agree on Help for Mexico." In an unusual bipartisan effort, we saw House Speaker, Newt Gingrich, and Senate Majority Leader, Robert Dole, teaming with Clinton on the Mexican plan which was being considered.

Actually, a few days before that, House Speaker, Mr. Gingrich, in a brief interview said he was sympathetic to the plan. Other prominent Republicans were also likely to be supportive because they come from border States linked to the Mexican economy.

"This is certainly a situation that cries out for some help," said Senate Budget Committee Chairman, Pete Domenici. He and others emphasized that the plan involved guarantees, not handouts.

Now, the Administration put forward a plan. The Administration is not the be-all and the end-all; Congress plays a role in developing this policy.

It seems to me incumbent on those who attack the Administration to have an alternative. What would they do instead? How would they propose to solve the problem? How serious is the problem? Does it need to be addressed? If it does need to be addressed, what needs to be done?

In a sense, I gather this hearing has some element of irrelevancy to it since, at the moment, there is an effort going on between the Administration and the congressional leadership to develop an alternative approach since people were not willing to accept the previous proposal.

I think the Administration has a responsibility to offer proposals, but I do not think they ought to be hung if Members of Congress are unwilling to carry the proposal. The burden then falls on the Members of Congress, assuming they think the problem needs to be addressed, to develop alternative proposals. As I read the Constitution, we help to make policy as well. In fact, in this instance, we are an essential part since you cannot proceed on the proposal unless you obtain congressional approval for it.

I am struck by the fact that the so-called congressional leadership seemed to be onboard to try to deal with these matters and now they are offboard.

That is, in a sense, neither here nor there, but it seems to me it comes with little grace for them to then engage in castigating and assaulting the Administration. They have a role to play as well, and they have a responsibility. If having committed to the approach, they then conclude that they cannot support it, it is their responsibility to develop a different approach.

Chairman Greenspan, I want to put two quotes to you and then I want to ask you a question because the Federal Open Market Committee is meeting today and tomorrow.

The New York Times carried a story on January 20, 1995, amongst which it had this statement:

> Uncertainty in Mexico was further increased today by revived reports that the American Federal Reserve would increase interest rates at the end of the month and thereby drain more investor money from Mexico. Finance minister Ortiz has said that the rise in American interest rates in 1994, was one of the reasons that international investors began to sour on Mexico, pulling their money out and putting it into safer investments in the United States.

Hobart Rowen, a couple of days before that, in an article said:

> The Fed's restrictive policy has not only boosted mortgage rates by more than 2 full points, stalling a housing boom, but it has also played a major role in triggering the monetary crisis in Mexico and potentially in other emerging markets in Latin America. It would appear that the Fed has been totally blind to the effects and consequences of its tight monetary policy on neighboring economies such as Mexico's. Yet, the Fed has now joined in what appears to be an open-ended commitment to guarantee loans of $40 billion a year or more to Mexico.

What is your response to those comments? As we are searching for ways to try to address this situation, is the Federal Reserve going to compound the difficulties and the problems by further increases in interest rates?

Mr. GREENSPAN. Senator, as I indicated to your colleague before, I think it is correct to say that some part of the withdrawal of funds from Mexico probably relates to higher dollar-denominated interest rates.

As best we can judge, it is a very small part of the problem and one need only look at the order of magnitude of the interest rate changes that have occurred in Mexico to get a sense of what is involved.

Any time any central bank does anything, it has all sorts of consequences. Indeed, in many respects, it's supposed to have many of them, but there are always secondary consequences which you would prefer did not happen.

You always make policy with respect to your fundamental goal. Our fundamental goal for monetary policy, as you well know, and

I've repeated it on many occasions, is to create an American economy with a sustained, long-term economic growth.

It's our judgment that, if we succeed in that endeavor, there is nothing that we could do which would be more helpful to our immediate neighbors.

I would merely suggest to you that there is, in our judgment, no trade-off of any important dimension in monetary policy which relates to trading off how we would respond to events in other countries and how we would respond to events in our country. As the central bank of the United States, our focus has to be the soundness of the American economy and the soundness of the American currency.

It is certainly our judgment that, if we succeed in that, that is what we can do most effectively for all of our trading partners, whether it be Mexico or any others with whom we deal.

The CHAIRMAN. Thank you, Mr. Chairman.

Before I turn to Senator Bennett, I would note that the Senator was absolutely right. This Senator has expressed an understanding of the importance of the problem and the fact that we should move in a way to do what we can to help in the crisis, but I think it is also our congressional responsibility and duty to recognize when a plan is deficient and may do little to deal with the problem and, indeed, may exacerbate the problem and, in this case, certainly jeopardize $40 billion worth of taxpayers' funds.

That is this Senator's position. It remains constant. It is not one that opposes developing a workable, intelligent plan. That's why we're having these hearings, to determine whether we could accept the plan that had been set forth. Now that it has been withdrawn, I think we should at least find out the dimensions of the problem and give our Members an opportunity to speak to those people who know about the problem, as well as interested citizens.

Senator Bennett.

OPENING COMMENTS OF SENATOR ROBERT F. BENNETT

Senator BENNETT. Thank you, Mr. Chairman.

Chairman Greenspan, I assume you've had a very casual and leisurely morning which made it possible for you to read this morning's paper. Specifically—and I am being facetious, I'm assuming quite the contrary—but is there an off-chance that you had an opportunity to read Miguel Mancera's piece in this morning's Wall Street Journal on Mexican monetary policy?

Mr. GREENSPAN. Senator, I had a chance to glance at it. I regret that I have just not had a chance to read it in detail. Until I do, I would not feel adequately briefed to be able to discuss it.

Senator BENNETT. OK. Let's talk about Mexicans printing pesos and the impact of that on this crisis.

Is it your sense that they are currently printing pesos and that we are in a circumstance where, if they don't stop, any kind of bailout from the United States would be a failure?

Do those two have to go together, that they've got to show some discipline on monetary supply?

Mr. GREENSPAN. Absolutely, Senator. Clearly, if you don't have sound monetary policies, in the future, there is no plan of guarantees that will succeed. Ultimately, the issue really rests on the

Mexicans. All we can do is basically be of support to their various actions.

My own impression of what it is that they ran into, as I have indicated in my prepared remarks, is a series of noneconomic events—the Chiapas uprising, the Colosio assassination, and then significant problems leading up to their August election.

I think their presumption was that the weakening of the demand for pesos, which occurred during that particular period, would not effectively continue after the election, and that there would be a restoration of confidence and a restoration of the demand for pesos.

One can look back, in retrospect, and say they were mistaken on that. Indeed, as I recall, the way I phrased it, they were tragically mistaken. There's no question that one looking back would say that the types of monetary policies that probably should have been in place should have been more stringent than they were. It's very easy with 20/20 hindsight to look back at events which were very difficult to forecast and say, it's too bad they didn't forecast them.

To respond to your question very directly, Senator, I don't think that anybody believes, or at least should believe, that guarantees solve any fundamental problem.

What they do is they create a basic temporary support for a currency or an economy so that more fundamental forces can be put in place to restore confidence in the currency.

If there are not appropriate actions to do that, I don't care what kind of guarantee program, what type of support program you impose, it just won't work.

Senator BENNETT. Let me share with you an analogy that I used in a press interview this morning when someone said, "Senator, you're a free market guy. Why do you want to intervene in Mexico at all? Why don't you just let the markets sort this out?"

I said, "Well, it comes down to your question of confidence. At one time in my career, several times in my career, I must confess, I presided over economic activity that was less than rewarding and found myself looking at losing my house or other devastation occurring in my life because I couldn't pay my bills.

"I went to my father and asked for a loan. My father, having confidence in my ability to eventually work things out, gave me that loan that tided me over to the next venture, which, fortunately, worked enough that I was not only able to pay the loan back, but pay him some interest and, before he died, even make some more substantial contributions to the family financial stability out of the success that I'd achieved.

"There was a basic confidence there, plus the fact, obviously, it was my father, that allowed him to give me that kind of a loan." He said, "I think you have the talent that you can make it work."

You've told us in other venues that you think the basic economy of Mexico is sound, and that we therefore should have this kind of confidence.

I am concerned, nonetheless, about the, for me, number-one demonstration of confidence in the world markets, which is the convertibility of the peso at a dependable rate. That is, you can depend on the fact that the peso will be worth the same 5 years from now, when the contract you've just signed for a new factory or a supplier relationship comes due. The rate will not be constantly shifting

whenever some economist in the International Monetary Fund says to you, "Well, you probably will get an advantage on your neighbor if you devalue a little."

The devastation that kind of attitude creates among business people who are trying to make long-term contracts, I think, is enormous. I've been trapped in one. I made a deal in Japan. I made a deal in yen, when the yen was 240 to the dollar. We had to pay it off when the yen was 120 to the dollar, and it wasn't fun.

Can we get any kind of understanding in this whole deal that addresses this whole issue of returning the peso to a level where there can be confidence in it, and a policy that says we're going to defend it at that level and keep it at that level, even if it means other things float according to market forces? Wouldn't that be a major step toward reestablishing confidence in Mexico and allowing people to go down and invest their money in it?

Mr. GREENSPAN. Senator, aside from all the various structures that one can conceive of with respect to what type of monetary regime you have, unless the underlying policies of a government are consistent with a stable currency, I don't care whatever type of device you employ, whether it's a currency board, a crawling peg, or fixed exchange rates of the type that many countries currently have in the EMS, it will not work unless you have a fundamentally sound set of economic policies which support a sound currency.

The reason, as you know, Senator, I've always supported the gold standard is the fact that I thought that particular mechanism was successful in creating an environment which induced individuals to behave in a manner that the currency was sacrosanct.

It never entered anybody's mind when the gold standard was actually functioning that there could be secular inflation because prices were tied basically to the gold standard, to value in gold and, as a consequence of that, you never got these types of problems emerging because no one dared take policies which would eventually force them to either go off the gold standard or to debase their currency.

What we have to recognize is that we cannot substitute, in today's context, anything which will effectively create that particular attitude. We must remember that what is crucial to all of this is, essentially, a set of attitudes about fiscal policies and monetary policies which are consistent with a stable currency, both domestically and internationally.

If you do that, it almost doesn't matter what currency regime you have. Your currency will be stable. Your prices will be stable. Your individual business people will be able to forecast a degree of stability in the future and not be caught with your 240 to 120 yen move which, clearly, is not very helpful to the progress of international trade and finance.

The CHAIRMAN. Senator Grams.

OPENING COMMENTS OF SENATOR ROD GRAMS

Senator GRAMS. Thank you very much, Mr. Chairman. I know the direction of this hearing has changed a little bit with the recent developments this morning, so I really don't have a question, but more of a concern. Hopefully, that can get a response, too, from Mr. Greenspan, Mr. Shafer, or both.

Really, the question now is what are some of the options that the President or the Administration is facing under this new scenario?

Mr. Sarbanes mentioned a while ago that the Administration is not the be-all, that Congress has a role to play in this, and I agree with that. Because the President and the Administration couldn't find support among American people for this guarantee, and what they were finding was a decreasing support in Congress, maybe now the decision is to go around this opposition, both nationwide and in Congress, and open the American checkbook, so to speak, through Executive Order.

I still don't know what the Korean deal is going to cost us in terms of the amount of dollars. There's a lot of talk about the Japanese and the South Koreans picking up some of the cost, but I think that's an open-ended question and that the American taxpayers are going to be at risk for some of that agreement that we don't know about.

So, the President, to go through Executive Order, I think what you should take back to the Administration is the concern, to remember that you are still going to be responsible for the bottom line to the American taxpayer, that, if the President goes back-door and offers some sort of guarantees through Executive Order without congressional oversight, I think the taxpayers are going to know that and they are still the ones that are going to have to pay the bill.

That's just some of my concern. I don't know if that would prompt a response or some of the talk that's going to be going on this afternoon.

Mr. Shafer?

Mr. SHAFER. Senator, I was told by one of my colleagues behind me that the President either has spoken or is speaking currently. Since I do not know what he is saying, I'm not in a position to comment on the options.

I certainly do know that all of us in the Administration are aware of our responsibility to the American people and the American taxpayers, and we'll bear that very much in mind in the course ahead.

Senator GRAMS. Like I say, my concern is what kind of liability are we going to put on the taxpayer without congressional oversight of this panel or of other Committee hearings like this? What are some of the options? How far can the President go? What is the cost?

Mr. SHAFER. I'm not in a position to say anything about that without knowing what he is saying or has said.

Senator GRAMS. Thank you, Mr. Chairman.

The CHAIRMAN. Senator, I might note that I just got a cursory report. Apparently, the new plan calls for $20 billion from the United States through the Exchange Stabilization Fund, $17 billion from the IMF, and $10 billion from a short-term facility from the World Bank, for a total of $47.5 billion.

It would appear, if that is the plan which is being advanced, that, at the very least, there is greater participation from the world community and some burden-sharing, something that many of us had questioned as it relates to the plan that had been put forth.

So, if congressional oversight has done anything, at least it has broadened the participation, and that is our responsibility.

I think Senator Grams raises a very legitimate question as it relates to what kind of oversight we have, and that is something that we'll have to look at as it relates to $20 billion, which comes from the Treasury through the Exchange Fund. That is something I'm sure we'll examine or we'll be briefed on in detail later on.

Senator Mack.

OPENING COMMENTS OF SENATOR CONNIE MACK

Senator MACK. Thank you, Mr. Chairman.

Since the fundamental issue is more about what the Mexicans do than we do, and even though we now have some indication of what the proposal may look like, I'd like to ask Mr. Shafer what kinds of actions the Treasury expected Mexico to take, regardless of whether it was with respect to this new plan or the old plan?

Again, I'm particularly addressing my concerns, at this point, with respect to monetary policy. As we observed in 1993, there was about a 3½, 4 percent growth in pesos to somewhere around 24-plus in 1994.

What was the Treasury expecting Mexico to do with respect to monetary and fiscal policy?

Mr. SHAFER. Senator, basically, the kinds of things that we've spoken to before——

Senator MACK. I'd like for you to be specific because we——

Mr. SHAFER. What we feel that Mexico needs to do, on its own behalf—and it is true that the most important burden rests on Mexico to see its way out of this—are, one, to have a sound and tightly controlled monetary policy.

Senator MACK. How is that going to come about?

Mr. SHAFER. May I list the four, and then I will come back and elaborate more on that?

Senator MACK. Sure. It's just that we've had some difficulty getting some responses out of you this morning. You'll understand why I was being a little bit pointed.

Mr. SHAFER. I understand that. I cannot speak to specific options that were going to be announced that I don't have, but I can speak to the issues I think that you've raised.

Senator MACK. Then please do.

Mr. SHAFER. One is that we look for a sound monetary policy, we look for tight control over fiscal policy, we look for a continuation of the kinds of economic reforms that open markets and free the markets in Mexico from regulation, and we look for continued privatization as the four elements that the President and Secretary Rubin emphasize as part of this package.

To return to the monetary policy, our perspective on that really is very similar to the one expressed a few minutes ago by Chairman Greenspan. That it is essential. It is at the core of reestablishing confidence and creating a long-run climate to bring in investment. It is essential that any country have sound control over monetary policy.

There is more than one way, and countries have succeeded in more than one way, to having a sound monetary policy.

Senator MACK. Be specific, if you would, as to what the Treasury was trying to get Mexico to do.

I realize that there are different ideas out there, but was there something that the Treasury thought would be helpful?

Mr. SHAFER. The Treasury has emphasized the need that it be a sound policy. We have not expressed a particular view that the currency, for example, must float or must be fixed. Countries have succeeded with both strategies with respect to the external value of the currency.

Senator MACK. How were the Mexicans supposed to know whether the policy they were putting together was going to be satisfactory to either Treasury, to the United States, or to the U.S. Congress with respect to the $40 billion in loan guarantees if you all weren't engaged in some kind of discussion with them about what it ought to look like?

Mr. SHAFER. We have stressed with them the importance of having a tightly controlled policy.

They have announced strict controls, stricter than they followed last year on the growth of the monetary aggregates and credit, and we think that is a good step.

If——

Senator MACK. If I could get you to hold just a second.

Mr. SHAFER. Yes.

Senator MACK. Mr. Chairman, Chairman Greenspan, what kind of things do you think Mexico could do to give confidence to the global financial community?

Mr. GREENSPAN. Senator, I've not been involved in the direct discussions on the specific conditions with respect to the loan package which is late lamented at this stage.

The general principle, and it differs from country to country and from one financial environment to another, which is inviolate is a noninflationary policy. The question of what constitutes that is not easy to write down unless you want to literally dictate certain monetary targets or create a situation, for example, in which you enforce a fixed exchange rate which would automatically determine what your monetary policy is.

Senator MACK. What we're talking about here and, again, you were very clear in your comments earlier, is a message that sends confidence.

Mr. GREENSPAN. Yes.

Senator MACK. If there is nothing more than the guarantees or some other plan—frankly, if the Mexican government does not follow policies that are generally perceived by the market to be in the interest of Mexico in the sense of maintaining a currency, then we're just going to have to keep putting money in after the situation.

Mr. GREENSPAN. No——

Senator MACK. So what do they do?

Mr. GREENSPAN. Let me respond to that in two ways.

First, in the specific instance, the monetary authorities in Mexico are fully aware of what constitutes a sound monetary policy. They just recently have gotten constitutional separation for the central bank.

Senator MACK. When did that take place?

Mr. GREENSPAN. I think in April, April 1, 1994.

Senator MACK. Which is the period of time in which the——

Mr. GREENSPAN. I was about to say, it takes a while before your institutional structure changes. I don't care what your legal structure is. I do think their knowledge is quite adequate to know what has to be done.

Far more importantly, no one has ever argued that any assistance is total assistance with no holds barred. It will be provided in tranches in one way or another. It is really up to the monetary authorities in Mexico to demonstrate that they have a noninflationary monetary policy.

If they fail, then I think it's inconceivable to me that the program would continue on.

The reason I would be hesitant to dictate very specific terms is that the markets are always in the process of change. I do think that everyone who is a central banker understands what price stability means and knows what policies in his particular financial environment go with that.

Now, I will not tell you that I don't discuss—we all do, all of the central bankers discuss with one another what we are doing, what we should be doing, and what are the important types of policies. One can stipulate in some detail. I'm not sure it should be necessary to do that.

Senator MACK. Let me go back to Mr. Shafer.

When was the first discussion the Treasury had with the Mexicans with respect to devaluation? What role did the Treasury have in suggesting policies of devaluation?

Mr. SHAFER. I don't know of specifically what, in fact, if any, discussions we've had on that subject. As you know, Senator, we are in the process of reviewing all of our documents pursuant to a request you've made for information on that. We have not, or at least I have not, seen the completed review to have a precise answer, which I hope we will be able to provide to you.

Senator MACK. Yes. But implied in your comments is that you may never have had any discussions with them about devaluation.

Mr. SHAFER. We have had discussions with them about exchange rates. The contents of those discussions, at various times, is something on which I do not have specific knowledge at this time.

The CHAIRMAN. Senator Shelby.

Senator SHELBY. When all is said and done, and a lot of things have been said and few things done thus far—you'd agree with that, wouldn't you, Mr. Secretary?

Mr. SHAFER. Excuse me? I didn't——

Senator SHELBY. I said, when all things are said and done, but up to now, there's been a lot said, but very few things have been done about the Mexican problem.

Mr. SHAFER. In terms of the response of the United States and the rest of the international community, we have not yet—we can read that in the judgment of the markets, at least up until the time I came up here—had a response that has mastered the situation. There have been a number of measures taken.

Senator SHELBY. But the market always responds to a situation, does it not?

Mr. SHAFER. Yes.

Senator SHELBY. OK. And the market has responded to this situation, basically, in a cautious, maybe negative way, a negative more than cautious way.

Mr. SHAFER. It depends on the situation. Certainly, the market lost confidence in the Mexican financial system in December.

Senator SHELBY. Absolutely.

Mr. SHAFER. We saw some recovery reflected in the markets and the expectation that the leadership and the Administration would be able to produce a package of support. For a while, there seemed to be some support from that.

You certainly could see in recent days, and especially yesterday, again, a very strong negative response to the growing sense that we were not going to be able to move forward on that path.

Senator SHELBY. Ultimately, isn't the real test going to be not just the shoring up of the Mexican financial crisis, assuming that is done one way or the other, but what the Mexican government does subsequent to that?

Mr. SHAFER. Absolutely, Senator.

Senator SHELBY. What are they going to do to right the ship in a long-term situation? What are they going to do to privatize more and more of the businesses in Mexico? What are they going to do to control the monetary creation, which some economists say has created or helped to create this current crisis?

What are they going to do to build on confidence in the international markets and, of course, investors to reinvest in Mexico, because this is not the first crisis we've had with our southern neighbor?

In 1982 we had a crisis. It's probably not the last, unless, sir, the Mexican government, backed by its people, decide to build an economic house that's stable from the outset, that looks into the current account situation and everything that goes with it. Is that right?

Mr. SHAFER. Senator, it is absolutely correct that durable stability of the Mexican economy and financial system rests most heavily on the actions of the Mexican authorities themselves.

It's also true that, at this time, the loss of confidence is such that they also need support, in addition to their own efforts, in order to restore that kind of stability.

Senator SHELBY. Will we be going back to the well? Looking at the history, and history is an indicator of a lot of things, economic history, too, we've been to the well before with our southern neighbor. Will we have to go again? Is this just a temporary bailout?

Isn't that a good question?

Mr. SHAFER. That is a good question, Senator.

Our conviction is that Mexico has the capacity, now, to put that history behind it. It has that capacity, in large part, because of the economic reforms, the liberalization, the opening up that has taken place, the privatization that has begun but must continue, and the new commitment to monetary stability in an independent central bank but, in fact, they must follow through and they must deliver on that record in order to durably put that tradition behind them.

Senator SHELBY. Sir, you used the word, capacity, that Mexico now has capacity.

They do have more economic capacity, more potential, but the ultimate question, do they have the economic and political willpower to do this?

Won't that be the test?

Mr. SHAFER. That would be the test, Senator.

Senator SHELBY. Thank you.

The CHAIRMAN. Senator Sarbanes.

Senator SARBANES. Chairman Greenspan, do you recall a meeting in the Capitol on Friday, January 13, 1995, in the morning, with well over 100 Members of Congress in attendance, where you and Secretary Rubin and Under Secretary Summers appeared to discuss this?

Mr. GREENSPAN. I do.

Senator SARBANES. There was an extended discussion. I think that meeting went well over a couple of hours, did it not?

Mr. GREENSPAN. I don't recall the specific time, but it was an extended meeting.

Senator SARBANES. Mr. Chairman, I would just make the observation, at the end of that meeting, as reported in the press the next day, House Speaker Gingrich told the gathering that the Republican leadership in the House stood firmly behind the Administration's rescue plan.

"The Republican leadership," he added, "is committed to doing everything we can to make it work."

Later in that story—"There's generally a consensus that, as the leadership agreed last night, we need to do what's necessary to make this work," Senate Majority Leader, Robert Dole, said after the morning meeting.

Now, I just put these quotes into the record to underscore the fact that the Administration had a plan. They came to the leadership of Congress. The leadership of Congress didn't say, "No, no, we need a different plan. Here is what we think." They said, "Well, we will try to carry this plan through."

They have not been able to do that. As we said, Congress makes judgments as well and, if it's going to work, it's got to have the President and Congress together putting this plan.

I know there was an outburst in here earlier, but the Wall Street Journal, actually just today, has a story, the headline on it—"Debate On Mexico Package Turns Into Early Test for GOP Presidential Hopefuls Dole and Gramm."

The rest of this article says, "It's a stage for the emerging battle in Republican Presidential politics." It goes on to discuss the interchange between Senator Dole and Senator Gramm.

I was not here earlier when, apparently, Senator Gramm was here and spoke about this matter, so I think it's important to put this thing into some context and to make the observation that the leadership in Congress was for this plan and was going to, as they said here, do everything they could to make it work.

Apparently, they have not been able to do that. Members of Congress have very differing views about this thing, obviously, and it has not been able to work and people, I guess, are going back to the drawing board.

I guess we will hear from other witnesses, and I am anxious to hear whether they accept the assumption that something needs to be done, and if it does, what it is that needs to be done.

It seems to me that some of the pyrotechnics that have apparently taken place here are not warranted in the light of these comments that I have just put into the record.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Sarbanes.

Before we call our next panel, I'm going to ask if Senator Frist or Senator Mack would like to ask this panel anything?

All right. We'll go to Senator Frist and Senator Mack but, first, I'd like to make an observation.

I don't think, Senator, it's fair to say that the leadership has signed on for a particular plan. I think the characterization of there being the general willingness to recognize the importance of coming up with a plan of action may be appropriate, but to say that the leadership has committed to this specific plan, I don't believe squares up with the facts.

Senator Dole asked me and others to look at the emerging plan, to work with the Administration to see if we could not be supportive and, indeed, make the necessary change so that the plan would be one that we could undertake.

I think, to be fair to all, it would be characterized as being sympathetic and supportive of the President's wish to undertake a rescue of the monetary collapse, the impending collapse in Mexico, but certainly conditioned upon there being appropriate action taken by the Mexican government and with appropriate safeguards and the word collateralization as it related to securing necessary promises so we would not be unduly risking taxpayers' money.

To say that we just signed on as such may be what a newspaper would characterize as a basic agreement by the leadership to work with the President. I think they were right in doing that.

I think, again, when we get to the specifics of it and we see it, as individual Members, we have a responsibility to say, wait a minute. There are deficiencies. I believe that to be the case.

I don't think there's any bad will or bad faith on anyone's part. Indeed, the leadership met today with the President and came to some agreement of some kind.

I was not there or privy to that but, certainly, I think they were acting in good faith, and individual Members have a right and a responsibility to call them the way they see them. If someone sees certain deficiencies, regardless of whether they're a Republican or a Democrat, they have the obligation to point that out to the Administration.

I'd just make that observation.

Senator SARBANES. Mr. Chairman, I would like to insert in the record the article that appeared in today's Wall Street Journal, headed, "Debate On Mexico Package Turns Into Early Test for GOP Presidential Hopefuls Dole and Gramm," which details a lot of the by-play that is going on with respect to this matter.

The CHAIRMAN. Again, that might be. Certainly, we'll have it put into the record as if read in its entirety. That might be.

That is certainly not an accurate reflection of this Senator and the responsibility that I have given to this in attempting to work

for 2 weeks with the Administration imposing and spending hours and hours with them. Nor do I think it is a fair and accurate representation of most of my colleagues.

Senator Frist.

OPENING COMMENTS OF SENATOR BILL FRIST

Senator FRIST. Thank you, Mr. Chairman. Just very briefly, in the interest of time, I do not have questions but I just want to reflect my perspective, coming at this as a new U.S. Senator, that I, too, want to put this above any sort of partisan back and forth.

I wasn't here earlier today, but I do want to stress the importance to the American people of addressing this fundamental problem and challenge that we have that will set a real precedent for the future of this country, to put this above any sort of partisan bickering back and forth.

I want to reassure the American people as to the mandate that I come to this U.S. Senate, and that is to be honest, straightforward, and recognize that what we do is going to set a precedent for the future.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Mack.

Senator MACK. Thank you, Mr. Chairman.

I want to follow on with Mr. Shafer on the points that you raised with respect to what the Treasury was pursuing with Mexico. I think you used the term, tight control on fiscal policy.

My concern, frankly, is if that tight control on fiscal policy is wage and price controls, high taxes on capital formation, I think we're headed in the wrong direction.

While, apparently, you did not give any kind of specific direction with monetary policy, did you, did the Treasury provide some specifics with respect to fiscal policy?

Mr. SHAFER. We have not yet, beyond our general ongoing dialog with the Mexicans, such as we have with any country, about the nature of their policies. We've not had detailed discussions of that.

Senator MACK. Then I'm going to interrupt you and I'll let you go on with the balance of the response.

The implication that a reasonable person wanting to be supportive of Mexico would not ask questions about what the deal's going to look like, somehow or another, involves politics, I think is rather ridiculous.

For the American people, through its Congress, to support a plan to assist Mexico, it is reasonable that someone ask the question, what's going to be done differently in the future as opposed to what happened in the past?

Again, I keep coming back to it being very helpful to us if we had some specifics about what's going to happen with monetary policy and what's going to happen with fiscal policy.

Mr. SHAFER. Senator, we have followed and taken note of the policy measures taken by the Mexican government since their crisis began in December.

We do feel that the new controls, tighter targets that they've announced for monetary policy, are appropriate, that the further budgetary adjustments, and that's what I meant by fiscal policy as

they've undertaken, are an important part of restoring confidence and financial stability to the country.

We were engaged in a process of trying to develop, between the Administration and Congress, an approach to support for Mexico. We had not, until that approach is defined, approached the Mexicans in detail to reach the specific kinds of agreements that would implement that approach. That still lies ahead of us.

Senator MACK. So that still needs to be done?

Mr. SHAFER. Yes, Senator, on whatever approach we decide, we have to find a course of going ahead and then reaching agreement with the Mexicans.

Senator MACK. Can you tell me what the agreement between the IMF and Mexico was, then?

Mr. SHAFER. There is a letter of intent between the IMF and Mexico.

Senator MACK. Are you privy to that?

Mr. SHAFER. What?

Senator MACK. Are you privy to that?

Mr. SHAFER. I am. In fact, it was released to the public, but I could not recite the details of it, and I don't have it with me here.

Senator MACK. Was the Treasury generally supportive of the positions taken by the IMF, or was the Treasury going to be in a position where it was saying that other economic policies should be used?

Mr. SHAFER. The IMF program that we saw certainly emphasized the right things and went in the right direction.

Senator MACK. Can you generally tell me what that was?

Mr. SHAFER. In terms of strict control over the monetary policy.

Senator MACK. How was that going to be done?

Mr. SHAFER. Through the setting of targets on the growth of money and credit in the economy.

Senator MACK. What about tax policy?

Mr. SHAFER. There were fiscal adjustments on the tax, especially on the expenditure side, in order to maintain a surplus in the budget deficit.

Senator MACK. Is it fair to conclude that Treasury's discussions with Mexico would be along similar lines?

Mr. SHAFER. I would expect that they would be along similar lines. I would not want to commit ourselves to every detail in that.

As I say, I couldn't recite every detail of that.

Senator MACK. At what point do you think Treasury and Mexico are going to come to a conclusion about what they think they might be doing?

Mr. SHAFER. We will pursue that as a first priority as soon as, as may have happened, we have decided on our course of action.

Senator MACK. There's been a lot said about the politics of this thing this morning. I think the problem, frankly, is that there has never been anything for anybody to get their hands on. For 2½ or 3 weeks, we've been asking people, what are the terms of the agreement? What are you trying to accomplish? We get conditionality.

So we ask, what does conditionality mean? We're still working on that. Here it is, we're having a hearing today and we've just had, apparently, another proposal put forward and, in essence, we're

still saying, it's conditionality and we're going to work out the terms somewhere along the line. Have faith and we'll come back and talk to you guys when we have it.

I find that really just incredibly troubling, really troubling.

I thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Let me thank you, Chairman Greenspan, and you, Mr. Shafer, both of you, for coming in under quite unusual circumstances, to say the least.

Mr. GREENSPAN. Thank you, Mr. Chairman.

The CHAIRMAN. I'm going to ask our next panelist, Mr. Seidman, William Seidman, former Chairman of the FDIC, and Ross Perot, if we can't combine it?

Mr. Perot? Mr. Seidman?

OPENING STATEMENT OF L. WILLIAM SEIDMAN CHAIRMAN OF THE BOARD, COMMERCIAL MORTGAGE ASSET CORPORATION; FORMER CHAIRMAN OF THE FDIC, WASHINGTON, DC

Mr. SEIDMAN. I have a brilliant presentation here on why the bailout plan was unacceptable. I gather that I don't need to bore you, Mr. Chairman, with that.

The CHAIRMAN. You might want to, for the benefit of those who care to listen, because some of us have expressed some concern and you might want to share with us, briefly, your major concerns. Then, with the indulgence of the Ranking Member, I'll put forth a question that you might want to touch on in your presentation—what do you believe should be the basis of any agreement in terms of basic fundamentals as it relates to Mexico being in the position where it can repay or get its house in order so that we don't have another repeat? What would you be looking for?

Mr. SEIDMAN. Thank you, Mr. Chairman.

First, let me just say, I think we've just seen a dramatic example of how American democracy works, how when the people, in their understanding of what's going on, believe that a plan put forward is unsound, that comes to be policy, even though we saw practically every one of the old leadership, if you will, subscribe to the plan.

When I wrote a piece 2 weeks ago called "Block the Bailout," it looked like it was a very tough assignment, so I feel very pleased that the President has gone back to the drawing board. In fact, I was going to end my testimony today by saying the best thing he could do to start stabilizing the situation would be to withdraw the plan. Unfortunately, by a few minutes, I didn't get to make that recommendation.

Senator SARBANES. Maybe they knew it was coming.

[Laughter.]

Mr. SEIDMAN. In any event, I think the plan was essentially unsound for many of the reasons that have been presented here.

First, it was very bad for the Mexicans. I think we still have this problem. That is, to the extent that we try to run the Mexican government, I think Senator Brown's statement was right on target. That was exactly what I would have said, although perhaps not as well, that it will make for very bad neighbors if we try to run Mexican economic policy.

Frankly, I agree with Senator Faircloth, that I haven't seen total evidence that we have our own policies under control without trying to run Mexico's policies.

So my first thing was that I thought it was very unsound for the Mexicans.

Second, I thought it was very bad for U.S. taxpayers. If we do $40 billion or even $20 billion, if that's where we're headed, we have such a stake that, if they want more, we're almost committed to provide more.

As someone who, if not an expert in bailouts, has spent a fair amount of time in bailouts, the possibility of that number going up is very high, and I think it is very unsound for us to get in that position.

So I think it's bad for the U.S. taxpayers and, with respect to the argument that we're going to export less to Mexico, of course we are. We've been exporting more than they can afford, and that's part of the heart of the problem.

Therefore, for us to try to institute policies that will allow Mexico to buy what they have been buying, it seems to me, is basically unsound.

Third, just on the basis of allowing private sector markets to work, we are essentially suggesting that we provide the discipline for the Mexican government instead of allowing the Mexican government to respond to market forces.

I have not yet seen a government that can regulate an economy as well as the market can, so my feeling was that this kind of intrusion in the marketplace would simply delay getting an answer to the problem. It would simply put our credit in place of Mexico's so that their credibility could not even be determined because all these investors who are panicking would be relying upon the U.S. credit, not the Mexican credit, and I think that is fundamentally unsound. I thought this plan was flawed from the beginning.

In addition, it clearly would have provided billions of dollars of windfall for investors, who I don't think this Government has any desire to help, or should have any desire to help.

Finally, Chairman Greenspan kept saying, "I would never help Mexico alone. I would only do this because of the spill-over effect."

There has been a spill-over effect and, in my judgment, it has been beneficial.

We had overheated markets in many places around the world, markets that were saying, don't bring us any more dollars. We have too many dollars now. Those overheated markets were moving into the same kind of problem.

The markets sent them a warning through Mexico, so I would say that the spill-over has been beneficial.

The idea that somehow the world will melt down if Mexico doesn't pay its debts is certainly belied by history. They haven't paid their debts for most of the 1980's. Not only that. They were accompanied by Brazil and Argentina and all the rest.

I would say, and I don't want to be political at all, but I would say that if there was a panic, it was at the top of our Government.

In other words, they rushed to provide a huge Government solution without really taking a hard look at it, and I think that has caused much of the instability that we now see.

I would conclude that the proposal, as put forward, was unsound and that it was actually, in effect, going to be counterproductive.

I agree that there's a major problem. The major problem, I think, was just tangentially talked about when Chairman Greenspan talked about the speed with which markets move now.

We do not have an international or a way of dealing with markets that move that fast, or markets where somebody can't pay. We have not yet developed a bankruptcy court for Mexican bonds that are defaulted on, so we need to address the situation of how we deal with these markets in terms of what we do when there is a failure. I think that's something we can get into very promptly.

We do have something for Orange County. We don't have anything for this world situation.

Beyond that, I believe we ought to look at helping Mexico restructure their debt. If Mexico can't pay today then they ought to pay tomorrow but, if they can't pay today, you can't get blood out of a turnip, so what we need to do is to help them restructure their debt. We need to help the IMF in becoming the policeman to the extent that there's going to be a policeman. We need to deal with this in a calm manner that reflects the fact that it's a problem, but it's not a world crisis.

I was going to end my statement, and I guess I should repeat it since it turns out to be fairly prophetic, by saying there's an old proverb that says, "No matter how far you've gone down the wrong road, turn back."

We just did.

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Seidman, we thank you, and it was very prophetic.

Mr. Perot, we welcome you.

OPENING STATEMENT OF ROSS PEROT, DALLAS, TX

Mr. PEROT. I'd like to commend you for having hearings on this issue.

I was embarrassed listening to the answers from the Federal Reserve and the State Department, but I'd like to compliment Bill Seidman for his positions and his clear-cut testimony.

I would urge the U.S. Government, in dealing with this problem, to bring in Bill Seidman one more time, if he's willing to suit up, and have him work with our Government and Mexico to put together the specific plan, that you couldn't get either the Federal Reserve or the State Department to even discuss, that we must have.

I thought Senator Mack's questions were logical, rational, and not time-sensitive, but he could not get an answer. You'd better bring in someone like Bill Seidman who knows how to get it done.

Senator SARBANES. Mr. Chairman, excuse me. I don't seem to have Mr. Perot's statement.

Mr. PEROT. That's because I wrote it out on the way up.

Senator SARBANES. Thank you.

[Laughter.]

Mr. PEROT. I was not surprised this morning that these hearings were disruptive. Controlling the story of the day is a consistent White House tactic.

The timing of the White House announcement is no accident because of the witnesses you have here today, specifically, Mr. Seidman.

Any time you asked, or any Member of this Committee asked, of your Government witnesses, what did you know and when did you know it, you got an evasive answer.

I consider that a red flare, particularly at a time when 81 percent of the American people, according to the L.A. Times poll, opposed the guarantee.

Let's look at the dynamics. Twenty-seven percent of the voters are Republicans, since we've gotten into politics today, 40 percent are Democrats, and 33 percent are independent.

Last November, millions of independent voters cast their votes for both Republicans and Democrats who wanted to reform our Government, put our financial house in order, and make the 21st century the best in our country's history for our children. They gave the Republicans a majority in the House and Senate.

I have a packet here for each Member of the Committee, none of whom are still—two of you were kind enough to stay. Anyhow, we've got a packet here for you, if you'd like to have it, that, I think, goes back to the big picture.

In the first one, Government, America's number-one growth industry. As we talk about Mexico, let's focus on what we're doing right here at home.

We have a second thing. Again and again, we've talked over the years that we really need an annual report in our Government like we have in businesses.

Now, you've heard all of the nonanswers that you've gotten here this morning. I am thrilled to show you the first annual report of the United States of America and to tell you how it was created. It's like the Wright Brothers built an airplane.

This was done by a college senior on her own time. She had to borrow the money to get it printed. When you go through it, you'll realize, this is a report written for every man, so that the average citizen can understand what's going on right here at home.

If you just open it up and look at the dollar bill and where your tax dollar goes, it's really interesting since we're talking about the Mexican debt, look all the way through there and you realize, we don't spend a penny out of the dollar bill to pay down our debt. We just roll it over and let it grow.

I've also included, so you get a red flare on where we are, the Alice Rivlin memo. I didn't include the memo, I included a graph.

On page 12 of her memo, she says, "In the year 2020, the increase in our debt will be equal to our Federal budget today, almost $1½ trillion. And in the year 2030, the increase in our debt one year will be $4.125 trillion."

That's not a good trend for our country and our children.

Our Government was hard at work on Government reform, bringing the debt under control, and now, suddenly, we're distracted by the Mexican problem.

Intelligent, well-educated Mexican leaders have exhausted their country's currency reserves by artificially propping up the value of the peso. You could not be more irresponsible. In business, this

would be criminal. I don't know whether it's criminal in Government, but you go to jail for this in business.

The end result, and this is the most important thing I'll say today, we haven't talked about what happened to the ordinary Mexican citizen, but millions of ordinary, good, decent Mexican citizens have been devastated.

Why would they do that? We'll talk about that.

As we analyze Mexico's financial problem, let's not forget that we, too, have a problem. The people have given you a mandate to deal with it, and if we don't deal with it we could find ourselves in a more difficult situation than Mexico because—if you don't listen to anything else I say today, please listen to this—nobody is going to bail us out. If we ever let this great country get into trouble, we are the bank and there is no bank of last resort for us.

As we deal with our problems, we tend to take them one at a time as though each one stands alone and is not linked in with other problems while, in fact, most of our problems are interrelated like pieces of a complicated puzzle. When we try to solve one of our problems without considering the consequences of all other matters related to it, things get worse, not better.

Congress has been focused on our core problem—to get our house back in order.

As we talk about helping Mexico, please remember—we cannot help other nations throughout the world unless we are financially strong. You've got to have cash to do it.

We must account for the taxpayers' money. We don't do a good job of that now.

I brought you another little booklet here. This is from Worth magazine and the theme of it is that Uncle Sam doesn't need good news to publish good numbers. When you read this, and you know this from your own experience, the stuff they put out for the American people is soft in many cases. One of the most gross examples is the unemployment figures.

That's detailed in this article. I hope you'll study it.

There's one more thing that I want to cover with you while we're still on the basics. That is page 25 of the President's budget. This is the budget of the U.S. Government, 1995, Analytical Perspectives.

When you go to page 25 there's a chart there that says it all. If we stay on the course that we're on now, the next generation to be born will pay an 82-percent tax rate. Little children being born tonight will pay an 82-percent tax rate, and there goes the American dream.

I included these documents to make one point. Mexico is in trouble, but we are not Daddy Warbucks. We've got to solve the problem.

Now, let's go to Mexico. They've got a $40 billion loan guarantee they want. They know they have a problem. A fundamental rule of lending for your banker is don't lend a borrower more than he needs because, if you lend too much money, the borrower gets reckless with the money and, if you lend him way too much money, then the person who loaned the money is at the mercy of the person who has the money.

If you can't remember the Don Trump situation, that tells a story. They loaned Don Trump so much money, they had to let him do whatever he wanted to do. We don't want to get into that trap.

The first questions a lender should ask are, do you really need $40 billion? Why do you need $40 billion? Exactly what are you going to do with it and how did you arrive at that number?

I don't think anybody that testified today would tell you what time it was from his own watch, much less answer questions like this.

[Laughter.]

You have a right to know this. The taxpayers have a right to know this because $40 billion is a lot of money.

Let me just give you some examples.

We built the Panama Canal for $387 million.

We ran this whole country, from its founding up through the beginning of World War I, over 100 years, for only $28 billion.

We fought and won World War I for $28.8 billion.

Our Federal budget in peacetime never exceeded $40 billion until 1950.

Now here's an interesting comparison. We put a man on the moon—this is everything we spent on space until we had Neil Armstrong on the moon—for $30 billion.

We rebuilt Europe after World War II, using the Marshall Plan, for $25 billion.

Our total foreign aid expenditures to every country in the world this year are only $16 billion.

We're going to give Russia, the one country in the world that we have got to help succeed in its quest for democracy, $375 million in foreign aid this year.

Total unemployment benefits in the United States are only $23 billion.

I have these numbers in your packet.

Let's put Mexico into perspective. Its economy is about the size of New Jersey's. Would the American taxpayer react favorably to giving $40 billion to bail out New Jersey?

I doubt it.

Now we're back to the first question—how did Mexico calculate the $40 billion? No one will answer that question. You've asked. I've asked. Everybody's asked. It's one of these conditionality things, tranches, and things like that.

I need a dictionary when I come up here to listen to this.

The point is, they either don't know or they won't tell us. When the dust clears, it will be out of your pocket, not their pocket. Hundreds of millions of people, over 100 million taxpayers in this country, are going to write the check with their hard work.

I think it was pulled out of the air. I don't think it was calculated. No banker in the world would loan you money that way.

The next question a lender would ask is what are you going to do with all this money?

We've tried to ask that question. Nobody will tell us. The answer is, and here's a soft one, restore confidence in the peso.

Then, your banker would ask, how many pesos are in circulation? The best figure I can get from our Government is 49 billion pesos are in circulation.

This is interesting. It would only take 9 billion U.S. dollars to buy every one of them. You still have $31 billion to go, so there must be more to it than that. I'd like to hear the answer to that one.

I'd like to know, as the person loaning the money and, since I'm a taxpayer, I'm one of the millions who are loaning the money, who owns these bonds?

You ask, why do we have a problem? Because all these folks gambled and lost.

You ask, who are the losers? It seems like nobody knows. Mexico is going to have to pay them off. The banks and investment banks and mutual funds know. That list exists. I can't think of a single reason why this Committee shouldn't have it.

Who owns the bonds? Who gambled?

Now, I understand investment. I understand risk. This is what I've done all my life. When you gamble and lose, you eat it. That's true with the lottery at the 7–11 store. That's true at the Kentucky Derby. That's true at the Super Bowl. It's also true in business.

If you could leave the Kentucky Derby and have someone come up to you and say, we'll finance this with Mexican oil receipts and, over a period of time, pay you back and pay you interest in the meantime, that would sure sound good to you, wouldn't it?

Nobody's ever going to do that. This is very unique.

We're looking after somebody. My question is who? The folks we're looking after are the folks who bought those high-risk securities. They were very sophisticated investors. They knew exactly what they were doing. If they can get folks working the third shift to bail them out, they'll do it in a minute and that's wrong.

Now, our Government is claiming, I'll feel your pain. Many small investors will be hurt.

OK, give me their names. Let's line it up. How much of this money is big investors? How much of it is small investors? Let's get the facts. If we just covered the small investors, we probably wouldn't even bother to have hearings.

Then, after you get all the facts, you can start putting the taxpayers at risk. As we do this, I hope every Member of this Congress will never forget that we have already put a $15 trillion burden on the U.S. taxpayers guaranteeing Federal programs from pension funds, to banks, to small investors, and Wall Street, and this includes a $1.4 trillion unfunded guarantee for U.S. Government pitching funds. The taxpayer shoulders can just carry so much.

I read we've got $28 billion in Tesobonos coming due in the near future and that Mexican investors own $10 billion, U.S. investors own about $12 billion, and that $6 billion is owned by Asian and European investors, with concentrations in Germany and Japan.

Once they start telling you that, they obviously have a list. I would like for someone in public life—let's assume Bill Seidman had this job and they said, we'll give it to you, but it can't be released.

I would feel it was in good hands because I've seen him, for so many years, work on these unsolvable problems and solve them. You can't get the questions answered.

Then—here is the key question—what created the crisis? Mexico exhausted its reserves, propping up the peso through November

1994, and now Mexico is out of money. They've got all of these well-educated economists. They've been marketed to us like superstar Government officials for the last several years. They're too smart to do anything like this. Why would they do something that is destined to fail? They had to prop up the peso to win the Presidential election in 1994.

Wait a minute. The election took place in August, but they continued propping up the peso until December.

In the last three Presidential elections, it's been a national custom to devalue the peso right after the election, but you do it before the new President comes in. This year, they waited until December, but things were different this year. We had elections in November and the United States didn't want a peso crisis until our elections were over.

Then why didn't Mexico devalue it in November? Because the United States had not passed GATT and knew it would fail if Mexico devalued the peso before it was devalued in late November.

There are a lot of questions and I want to be around when they get answered.

Did Mexico discuss this plan with United States officials? When? You heard that asked this morning. You got no answers.

Who was in these discussions? If there has ever been a time when it is logical to ask, what did you know and when did you know it, now is the time.

Who was involved in these discussions? We don't know that. Did United States officials ask Mexico to devalue the peso? I'd love to get that snake on the table.

Did U.S. officials promise to support the peso in return? What did President Clinton know before he went to Miami to the Summit of the Americas, in November 1994, pronouncing everything that happened so far a roaring success? Everybody in the investment business knew the peso was in the can at that point. It was in intensive care. It was just a question of what we'd have to do to bail it out, but we didn't talk about that until the right time.

Did any U.S. officials promise former President Salinas that they would support him as the head of the World Trade Organization in return for propping up the peso?

In summary, what did they know and when did they know it?

We haven't gotten any answers to those questions. I've asked them again and again. I heard you ask them this morning. It's my understanding that a who's who of the House and Senate have been asking.

Now we've got—I love the Chicken Little theory—the sky is falling. When you get past tranches and conditionality, when you get to the sky is falling, they get down to plain language.

We have to do this because if we don't make this $40 billion guarantee immediately, the flood of illegal immigrants flooding our borders will be in a runaway situation. Give me a break.

The Mexican austerity program, which we imposed on Mexico as a condition of the guarantee, keeps the peso down, cuts the pay of the Mexican worker, and ensures that, no matter whether you have the guarantee or not or whether you put the guarantee in and you put that austerity program in, they're going to have to come across the border for food.

Who gets hurt most by this austerity program? Let's put some faces on it.

You have three photographs in your package. These are Mexicans. Interestingly enough, they work for U.S. companies. These are not the destitute Mexicans.

Here's a family outside a shack made from old boxes and cardboard. Here's a man hard at work building his cardboard shack with a dirt floor. In the Miami Herald, one Mexican, who worked for a major U.S. electronics company, said his dream some day was to own an outhouse for his family. His contemporaries back in the United States were asked the same question. Their dream was to send their children to college.

Now you say, Ross, you probably had someone go all over Mexico just to get those. No. Do you want to see a whole community? There it is right there. All you have to do is go down there to see how the Mexican people were living before this happened. Now it's happened.

The Mexican middle class and the poor Mexicans are going to get hurt. How does Mexico define middle class?

You ain't going to believe this.

Middle class is having a paycheck large enough to buy food for one month. If you can buy food for more than one month, you're above middle class.

How many people fall into this class, which we would consider poverty? Only 4.3 million out of 91 million Mexicans. I'm sure you all are asking, Ross, where did you get these numbers? From Mexico, the Mexican government.

How many Mexicans fall into the category of living in poverty? Eighty million people live in poverty in Mexico.

How much do the Mexican workers make? I've got another chart in there for you that tells this story. I hope you find it useful as you think about this because you need to think of it in human terms.

This shows what happens when a government constantly devalues its currency. Keep in mind, in Mexico, you've got 35 people who own over half the country, 35 families. Mexico had two billionaires in 1991. In early 1994, they had 26. That's a unique concentration of wealth.

Guess who's taken some hits on the high coupon Tesobonos? The 35 families and the Mexican banks. Guess who wants the U.S. taxpayer to bail them out? Guess why they don't want you to see the list?

I just told you why.

Here, the Mexican workers made $9 a day in 1981. You've heard about how wonderful things are in Mexico and all the progress that has been made but, when you get down to where the rubber meets the road, where 80 million of the 91 million people live, median range in 1993 was $3.13 a day. That's before devaluation. You knock 40 percent off of that and it turns into $1.88 a day. If you see illegal immigration increase, you know exactly why.

Wages have been cut 40 percent. The cost of food and other basic items have increased by 40 percent, even though the government is trying to hold them down. It's a double hit for these poor people in Mexico.

Some of the workers that work for U.S. companies make as much as $10 a day. They are now effectively, with a 40 percent cut, making $6 a day. The workers who are at the minimum wage, at around $3.13 a day, are now making $1.88 a day because of the 40 percent cut.

Did it serve any useful purpose, or productive purpose, for Mexico's leaders to exhaust the country's reserve and prop up the peso through the Mexican elections, the U.S. elections, and the passage of GATT?

I told you how it devastated people. That's why they did it. Did it serve a purpose?

It served no constructive purpose, but it helped the politicians, both in Mexico and the United States, and it devastated 80 million people. Let's get that card on the table.

I've already covered the new austerity plan. It does not help the poor people. It's aimed at letting them carry the burden to get Mexico back on its feet.

The 35 families that own over half of the gross domestic product are helped, because they invested in the Tesobonos, if we bail them out. The banks that they own are helped because we're now giving U.S. banks a chance to rush in.

Here's the man that's still got the scars from the bankers' irresponsible behavior. I'm not too excited about our bankers rushing in to buy big chunks of Mexico banks right now when they're in deep trouble. I'm not smart enough to know whether the FDIC covers that. He will know. We ought to get that card on the table because we don't need to go through that again.

Our biggest banks will be the first to rush down there because they want to be international.

The goal is to keep the wages down because that attracts businesses to Mexico. Before the devaluation, you could hire ten Mexican workers for one U.S. worker.

Is the Mexican government honest?

We just praise and genuflect everything they do. Let's get down to plain talk. No. The politicians leave office much richer than when they were elected. In some of their cities, the police chief lives in the finest house in town. That sends a message.

Mexico is now a huge shipment platform for cocaine to the United States. We have a tragic story, and I gave you a copy of that, in terms of the Wall Street Journal story that's printed here. It tells about the drug cartel in Mexico, it tells about buying old U.S. planes from our big airlines, gutting them, carrying as much as $120 million of cocaine for shipment, landing them anywhere, and abandoning the airplane because there's so much profit.

It details the government officials that have been paid millions. It quotes one U.S. drug enforcement agent named Phil Jordan. The tragic end of this story—this story appeared on December 13th and, 2 weeks later, his brother was murdered by an illegal alien in El Paso.

The good news is they captured him. The bad news is we still don't know what the ties are. It's a sad coincidence. Here's a man that gives his life to trying to clean it up and pays a price like that for having his name mentioned in the paper.

When you read about the details of that cartel, how brutal it is, and the fact that it's wired to the Mexican government, I wouldn't lend them a nickel until they cleaned up their government because it's a government that's not responsive to the people.

Any lender would want to know, will the borrower pay back the money?

While we were fighting the Civil War, France invaded Mexico because they didn't pay their debts. Not many people think back that far.

Mexico defaulted on its loans in the 1930's, and did it again in 1982. We had to bail out Mexico with the Brady bonds. One question that never comes up is how many Brady bonds are out there, because you and I could get stuck with that.

The Financial Times reports $127 billion in Brady bonds are outstanding. We ought to double-check that number. If that's true, that is a whole lot bigger than $40 billion and we need to know exactly what the status of those is.

So there we are.

Now, we also want to know who's going to lose the money? Big investors will lose the money. They're sophisticated investors. They gambled and lost. Here is the sad part of the story. I gave you another little piece of information on how they could have hedged their investment against a decline in the peso. It would have cost them 1 percent. Most of them didn't even bother to do it, and they know to do it.

If I came to all of you and said, my car was just wrecked last night. I don't have it insured. I didn't bother to insure it. Would you buy me a new car? I think most of you would say, Ross, that's a silly request. Next, you would say, we would be encouraging you to continue to act irresponsibly. No, we're not going to do that.

When investors lose, they always whine. They always love to have someone bail them out. Anybody that does should remember P.T. Barnum's statement—there's a sucker born every minute. When you gamble and lose, you should step up to the plate and take responsibility for your loss.

There is a solution, so let's just get right down to the solution.

Our Secretary of Treasury and the White House had negotiated strong collateral. Both the President and the Secretary of Treasury assure us that this is liquid gold, bulletproof collateral that the Mexican government has come up with in their petroleum receipts.

Terrific. I love it. I got all excited when I read that because I realized that's the kind of stuff bankers fight over.

We don't have to put the taxpayer in the middle of this. We've made a huge mistake talking about putting the taxpayer in the middle of it. Everybody wants the United States to get in the middle of it so that they can get their money back quickly, and you and I may or may not ever get our money back.

What the U.S. Government has to do in this situation is very politely tell everybody, say, folks, we can't ask the American taxpayers to bail out irresponsible behavior. Your government officials shouldn't have just pillaged the treasury or robbed the bank to win the elections. That's wrong. We can't pay for that.

The good news is you have all this oil collateral. The great news is you have all these people who have worthless paper. Sit down

with them with your oil collateral. Give them new securities. Pay them interest and principal over time, and there is a happy ending to the story nobody's heard.

Listen to all these comments from these folks who have Ph.D.'s and I'm not sure what else, but they're all highly educated, about how, if you don't rescue every tiny little country in the world, the sky will fall. Anybody that buys that, give me a call collect because I've got stuff in the attic to sell to you. Stuff that I can't even get the trashman to haul away.

People are going to ask me, I know, can we just step aside and say, you try to work it out and, if it doesn't work out, Uncle Sam will be right there with you?

Oh, no. If you understand Wall Street, if you understand investors, you've got to pull the plug and walk away. As long as they think they can lure you back in, there's no chance they're going to take the risk. They don't have to when you can spread it over every hard-working American.

Think of those folks working second and third shift. Is it fair to ask them to clean up this mess? No. If we ask them to clean up this mess, are we any better than those Mexican officials who took the money out of the Treasury and used it to win an election?

No.

Keep focused on the 80 million good people in Mexico just working hard for a living. They are great people. They are great workers. If you look at their productivity, you'd say, there is tremendous potential in this country. That potential shouldn't come from using and abusing 90 percent of the population.

History teaches us that if you abuse the workers, you pay a terrible price in the future. I can talk to you for an hour about that. If you treat them with dignity and respect and pay them a fair wage, you don't have that problem.

In closing, if we guarantee $40 billion, we set a precedent that's going to harm us forever.

You couldn't get an answer on anything from these fellows from the Federal Reserve but, from a sailor with no training, I'm going to tell you what the other currencies are that are in trouble. Anybody that can read comic books knows it because it's printed everywhere.

Canada's currency is in trouble. We've had a tremendous decline in the Canadian dollar. Within the next 6 months, they will have to devalue it or clean up the way they do business in Canada, and there's a ticking bomb on that one, in that Quebec is going to have a vote to secede and if Quebec breaks away from Canada, if they're smart at all, they're going to leave the debt behind.

If you're going to break away from a country, why would you want to take a piece of the debt with you, unless you're just a true charitable person?

If you're mad enough to want to break away, leave them with the problem and you start clean.

Next, Italy's currency is in trouble. Spain's currency is in trouble. Sweden's currency is weak. We've got several South American countries, I won't go into all of them, that may have currency devaluation soon. They will expect us to rescue them, just as we rescued Mexico, and how could we tell them we wouldn't?

We have a simple problem, folks. We can't afford to do this. We are so used to being the richest nation in the world, and we have been rich for so long, that we just take it for granted but, when you look in the cupboard and the cupboard is bare and we're $4.8 trillion in debt, we simply can't follow every charitable impulse we have because, if we do, we will destroy this country and that will make us completely incapable of helping people around the world, which we all want to do.

We do have a bulletproof, fail-safe way to get it done. Anybody that understands business, just wink at these bankers. Wink at these folks that bought the bonds. Say, you have liquid gold here. Sit down. Work it out.

You say, Ross, do people with experience in all of this say it makes sense? Yes. If you read Mr. Seidman's column, which I put in here for you to read, that's his solution. You've got the collateral. You've got everything that it takes to make a deal. Make the deal.

If someone asked, how would you get that done quickly, I'd say, get people like Bill Seidman. I would urge that person to get someone who really knows the oil business and how to horse-trade.

He knows how to horse-trade. Most people don't know how to horse-trade. Everybody at the table better know how to horse-trade because this is a negotiation. Work it out. I think you would be shocked at how quickly——

The CHAIRMAN. Mr. Perot, are you suggesting that instead of paying 100 cents on the dollar, plus the 20 percent return, or the 19.8 that most of these Tesobonos have, that the government of Mexico would have the temerity of saying, guess what? I can't pay you today. And guess what? Maybe you'll take 60 cents on the dollar and no interest and I'll pay you out over 4 or 5 years.

Mr. PEROT. The President of the United States and the Secretary of the Treasury have gone to the American people and indicated that they're going to get paid a dollar on a dollar plus interest.

Now that doesn't take much temerity.

The CHAIRMAN. I mean, are you suggesting a restructuring, like is done in the private sectors here in this country?

Mr. PEROT. Absolutely.

The CHAIRMAN. Bill Seidman, what do you say?

Mr. SEIDMAN. That's what I suggested in my piece, is that they need to get together and get it settled in the good old American way, over the bargaining table.

Mr. PEROT. It wouldn't take but a few days but, as long as they think Uncle Sam is going to play Daddy Warbucks, they're going to grab for it because that's instant. If I can get all my money back today, then I can go gamble in some other undeveloped country.

The CHAIRMAN. Plus interest.

Mr. PEROT. Yes, plus interest. Then I'll lunch off of some other undeveloped country and roll the dice, counting on you to show up when the flares go up.

On the other hand, if I have to sit down and get my principal and interest back over 5 years, I can't complain. That's a lot better than a lot of folks got around the banks, isn't it, Bill?

Mr. SEIDMAN. It certainly is. What I love about this is how well Ross presents my plan, see?

[Laughter.]

He's extraordinary. I love to be with you, Ross. You do such a great job.

The CHAIRMAN. Bill, have you suggested, then, that the time-old tradition where a person who cannot meet his obligations sits down with the creditors and says, these are the assets I have. I can afford to pay you over a period of 5 years, but maybe not today. I cannot give you your 20 percent interest and I may only be able to pay you a portion of that which you invested.

Instead of dollar for dollar, it might be a percentage, 60 percent, 70 percent, or even somewhat less.

Is that what you're suggesting?

Mr. SEIDMAN. I'm suggesting that ought to be worked out between the debtor and the creditor.

The CHAIRMAN. That's the capitalist system in America, isn't it?

Mr. SEIDMAN. It is the system and it's worked before. It's not like we're inventing something that's never been done before.

The CHAIRMAN. It's done everyday in this country.

Mr. SEIDMAN. And it was done with Mexico last time. So we're not exploring something that's never been done.

The CHAIRMAN. I have to ask a question, then I'll turn to Senator Sarbanes. I'll put it in the form of something that has bothered me.

It bothers me to think that there are people who, as recently as last week and the week before, would have the ability to come with paper that they just purchased, some getting 20 percent, 25 percent, some maybe as high as 40 percent, and that we're going to pay them off or make it possible for them to get paid off dollar for dollar, plus this wonderful premium.

Now, people take risks. Should we, if the risk goes sour, if the business venture goes sour, then come in and say we're not going to hold you accountable? We're not only going to hold you unaccountable, but we're also going to give you that premium that you had for taking a very speculative investment?

That's where this Senator has some difficulty, notwithstanding that I think the conditions of the agreement and the collateral are insufficient, but there's something that flies right in the face of the free market system. Just last Friday, the Chief of Staff of the Mexican President came in and he told us—let me give you his name—Louis Teles—that there was $180 billion worth of debt, and that $70 billion, not $28 billion, was short-term.

Now, I wonder how you're going to provide sufficient guarantee with $40 billion if $70 billion is short-term? Aren't those people who have an opportunity to cash in and get their premium going to cash in, or would they roll over if they know there is a guarantee for them?

How many fiduciaries in this country would simply say, oh, I'll postpone taking my money out for another 10 years, if they know there's a guarantee?

Mr. PEROT. None. They'll take it immediately. That's why the Government needs to disappear.

I think, from Congress' point of view, we are sitting here seriously, and the White House has a brand new plan that, based on everything that I heard this morning, is not going to work, either. It keeps this flame alive and delays what I call the basic meeting of the investors and the debtor.

That's going on. We're determined to protect the rich at the same time we're having hearings all over the place about cutting spending on welfare, so on and so forth, in this country.

Only in America could that happen at the same time. Think of all the programs we have to cut to bring our house in order, and now we want to ship money to Mexico or somewhere else.

Mr. SEIDMAN. There's something awful that happens to people when they get in Government, Mr. Chairman. I've been there. They begin to think that, if there's a problem, they have to have the solution and that they have to use the resources which they see around them to prove they can handle the problem.

I think that kind of thinking has, unfortunately, gone all the way through the suggestions that have been made here. As we all know, this decision was made at the highest level, very quickly, with very little comment, staffing out, or anything. That's why I hope they go all the way back to the start and not just to a substitute that they can get around Congress. After all, it's Congress that has reflected the American people's desire not to have a bailout.

Mr. PEROT. I have one plain language thought that every Member of Congress should ask their constituents.

Go to every congressional district in the United States and ask the people who live and work there, are you folks in this district willing to pony up about $100 million so that, when we pile it all up together, we've got $40 billion for Mexico?

I don't even think you're going to get a conversation going.

Then you say let's go to the State level. It's $800 million at the State level that you've got to pony up.

Forty billion dollars is a huge sum, and you pointed out, correctly, that we're not sure that's right.

I would not loan a person half as much money as that person needed to accomplish a mission, right? You've seen that in your banking experience. That is a sure-fire suicide loan. You've got to have enough money.

Step one is how much do you need? Why do you need it? What's your collateral?

Now, let's focus on the positive. The Secretary of the Treasury ran Goldman Sachs. He understands collateral when he sees it.

All the bright people in the White House have said this collateral is liquid gold. Terrific. Let's take liquid gold, lay it on the table. We can work out a deal with any bank in the country.

It's just sitting there waiting to happen, but nobody will touch it if Uncle Sam will come in and say I'll take care of you, but Uncle Sam doesn't have any money, Senator.

The CHAIRMAN. Let me turn to my colleague, who has been very, very patient, and I'm sure he has some observations or some questions to ask.

Senator Sarbanes.

Senator SARBANES. I will be very brief, Mr. Chairman, because I know the hearing has gone on quite long. I would like to question Mr. Perot first, then I will turn to Mr. Seidman.

Is it your position that Mexico has a problem, but neither the United States nor the international community should be called upon to address it?

Mr. PEROT. Mexico has a problem created by corrupt politicians. I would like to know when we first knew about it and how involved our people here in Washington were in keeping that problem alive all through 1994, through the election.

Senator SARBANES. I am accepting all of that. I don't want to argue that with you.

Mr. PEROT. No.

Senator SARBANES. I will accept that premise.

Mr. PEROT. You see, this is a problem created by corruption. That's the point I'm making.

Senator SARBANES. Do you think anything needs to be done now by governments or international institutions about the Mexican situation?

Mr. PEROT. Yes.

Senator SARBANES. You do.

Mr. PEROT. Yes, sir.

Senator SARBANES. OK. I did not understand your testimony because I thought your position was that it should be left alone.

Mr. PEROT. No. Absolutely not. There is a key role. May I tell you what it is?

Call everybody involved into a room, look at them very nicely and smile and say, fellows, you got the collateral. We did that for you. That is a tremendous contribution by the United States of America.

Now, you're all grown. You're all sophisticated.

Senator SARBANES. Who would call them into the room?

Mr. PEROT. Sit down. Work it out. We're out of here. That's my proposal, that the Government get involved, introduce them to one another, and hand them the collateral.

Senator SARBANES. Who is it the Government would call and introduce to one another?

Mr. PEROT. Mexico, the Tesobono-holders of the securities, and you'd probably have, when you get that, a bunch of banks. A lot of banks played in this game. A lot of U.S. banks played in this game.

They're all going to sit down. Down deep in their souls—normally, in a situation like this, there is no security. Here, we've got liquid gold. When the Secretary of the Treasury, with this background, announces it bullet-proof, that's quite a compliment. When the President and all the people around him go to the American people and tell us it's a guarantee we'll never have to pay, that means the collateral is bullet-proof. That means we don't have to touch it.

Senator SARBANES. Who would call all of these people together?

Mr. PEROT. The President.

Senator SARBANES. I see. So you would have a meeting of all of the holders of the Tesobonos.

Mr. PEROT. And the bankers and the Mexican government, everybody involved, and you'd say, fellows, there's good news tonight, as Gabriel Heater used to say. We've got collateral. We're handing it to you. We're out of here. God bless you all. Don't chase cars again. That's our only advice.

Senator SARBANES. Actually, I thought Gabriel Heater always used to say there's bad news tonight.

Mr. PEROT. I must have heard him on the good night.

Senator SARBANES. That is my recollection.

[Laughter.]

He always said, "Bad news tonight."

So you would not have the IMF, the Bank of International Settlements, or any of them, play any part.

Mr. PEROT. I wouldn't and, after listening to them this morning, I wouldn't want them around me.

Senator SARBANES. Listening to whom?

Mr. PEROT. The folks that talked today.

Senator SARBANES. We did not have anyone from the IMF or the BIS. Should they play a role?

Mr. PEROT. No, no, no, no, no. As long as you have anybody around it like that—now keep in mind——

Senator SARBANES. I understand.

Mr. PEROT. —these investors are smart, cunning, and manipulative and they are going to play this piano in a way that nobody else can.

Senator SARBANES. I just want to find out.

Mr. PEROT. Nobody around it. No.

Senator SARBANES. One position is to say, look, it is your problem. You take care of it. Period. We are out of it completely.

Mr. PEROT. And I would ask Bill Seidman to come in and help, I'd say, now, if Bill Seidman's willing to come back in and work with you guys to work this out, and probably, in about 3 days, Bill would be bored to death because it would be done. It's not that big a deal.

Senator SARBANES. Why should we undertake to work it out?

Mr. PEROT. Because that's better than having it just—you don't have to. That's a good point.

I would say the reason I would suggest doing it is because we hold the aces now. We've got the collateral. Rather than throw it up in the air and walk away, I'd say let's get everybody together with this collateral. It's a slam-dunk, done deal.

Senator SARBANES. What collateral do we hold?

Mr. PEROT. The oil receipts that Mexico has pledged. We don't hold it, but they say they'll pledge it. If you ask if I know every detail about that collateral, no, because no one will tell me, but if a man with Secretary Rubin's background blesses it as he has, it's got to be great. Everybody in the White House has blessed it. A lot of people with a lot of experience have. You don't go to the American people and say something is fireproof and bullet-proof until you check it. I'm taking their word for it.

They just need somebody. They need a wise man like Bill Seidman to pull them together. They'll spend the first day saying, but won't Uncle Sam come to take us off the hook today? He's been there before. He knows how to answer those questions.

Then, they realize they have to do it and they'll go do it. We'll go on to the next problem. We can go back to working on Government reform and getting our own house in order.

Senator SARBANES. But it is not your position that we should just say, it is your problem and we're not going to pay any attention to it.

Mr. PEROT. Just for one reason, and that is, I don't want to lose that collateral.

Senator SARBANES. You do not have the collateral.

Mr. PEROT. No—excuse me. I don't want that to disappear from the picture. I think the Government can be a neat bridge to keep the collateral intact, get the direct negotiation going, and disappear.

Senator SARBANES. Why would that be the case? If the collateral is available, why wouldn't it develop if they were just left alone to address the problem on their own? Why do we have to be drawn into it at all?

Mr. PEROT. You're dealing with shrewd negotiators south of the border. We don't have many left here. We've got one sitting to the right of me.

The minute the Government walks away, they're going to pout. They're going to talk about sovereignty. They're going to tell you the old story of the oil from the Rockefeller days.

Now, this is nothing but posturing to sit back down at the table and make another deal but, here in the good old U.S.A., most of us don't know how to negotiate and, if they say the hammer is $5.95, we pay for it. If you say the hammer is $5.95 in Mexico, they say, I'll give you $2.

So, we'll have to go through that again. Our Government has done that. Our Government has done a great job of it. Let's not give it up.

Senator SARBANES. Now, you have put up as at risk this morning Canada, Italy, Spain——

Mr. PEROT. Spain, Sweden.

Senator SARBANES. —Sweden.

Mr. PEROT. And several South American countries.

Senator SARBANES. Yes. Which ones?

Mr. PEROT. I'll have to go back to my list. I don't want to put one on there by accident. The ones I've mentioned have been written up extensively in the paper.

See, I don't think we damage a country—for example, everybody in the world has written up Canada's problem. I haven't told you a thing today that you couldn't read in the paper, and Canada is the big gorilla.

Senator SARBANES. Do you think we should concern ourselves about Canada or should we just leave them alone?

Mr. PEROT. If you've got to do this, if you feel a tiny need to do this for Mexico, you will have a compulsive requirement to do it for Canada.

Canada is the big brother in this trade agreement. Mexico is the tiny little brother. Right now, we do a whole lot more business with Canada than we do with Mexico. One thing that I didn't cover today that I should have covered is that we have a $15 billion trade deficit with Canada. We have had a small trade surplus with Mexico that just shifted and is going to be anywhere from a $5 billion to a $10 billion trade deficit next year.

So, right now, we have what we don't want with both countries, and that's a trade deficit where they are selling far more to us than we're selling to them.

We get oil from Canada. We get gas from Canada and on and on and on. We've got another common border.

If you said you can only help one country, a pragmatist would head north, not south. If we help Mexico, when Canada gets in trouble, we've got to be up there. We don't have the money.

Senator SARBANES. So, I take it the conclusion, then, is that we should not be into it with respect to any of these countries.

Mr. PEROT. Our Government should not be involved.

There's good news in Canada. They've got oil and gas. If we set the precedent, the private sector did a petroleum receipts deal, maybe you could work that same thing out up in Canada. It would be a little more difficult because they don't have a nationalized oil company like Mexico does.

Again, at a time when we're saying that we're no longer going to reward irresponsible behavior with poor people on welfare, we're saying, but we have to reward irresponsible behavior with rich people who gamble money. I don't think that will sell down in grassroots America.

Senator SARBANES. Mr. Seidman, would you want to preside over a meeting of all of the holders of these Mexican bonds?

Mr. SEIDMAN. To tell you the truth, I haven't given it any consideration, but it sounds very appealing.

[Laughter.]

I thank my friend, Ross, for the confidence he has in me, but I think this Government does have an obligation to try to facilitate a settlement of this as quickly as possible, but not to subsidize the settlement.

Senator SARBANES. Why do we have that obligation?

Mr. SEIDMAN. We have that obligation because we have a neighbor on our border that is in trouble, and we're trying to facilitate a way to get them out of that trouble in the best way we know how, which is for them to sit down with the people they owe money to and work it out.

It's just the same as for any company that has gotten into trouble in our country. We want to reorganize it so the workers will be able to work, so they can get back to making money. It's exactly the same thing.

Senator SARBANES. Why should we undertake to do that? You say in your article something about the creditors and the debtors working this thing out between themselves.

Mr. SEIDMAN. And I say in there that we ought to help facilitate.

Senator SARBANES. Why don't we leave it at that?

Mr. SEIDMAN. I think we ought to help facilitate that just the way a bankruptcy court does if you're in a country.

That's exactly what we need, but that's what we don't have. The IMF does that, to some extent, but the problem with the IMF is that very often they use money to get it done and somebody grabs it.

Mr. PEROT. May I make a comment, please?

I understand that Mr. Seidman wouldn't want to do this but, since we're talking about high-risk investments and what have you, I would be glad to gamble with anybody that wants to bet, if he is asked by the Federal Government to do it and is given the right environment in which to carry it out, that, no matter how much of

a sacrifice it is for him personally, he will do it because of the kind of man he is, and I will not ask the Government to cover me if I lose because I took my risk.

[Laughter.]

I know it's probably hard for the folks in Washington to understand that I won't ask for help, but I took the risk. I would certainly make that bet.

There's one other person that I would propose. You need somebody that understands oil and gas. Bill may have somebody better, but there's a tough, shrewd guy down there in Texas, used to be Governor of Texas, used to be Deputy Secretary of Defense, that knows the oil business cold. His name is Bill Clemmons.

Let me say this, if I had to be on the other side of the table—if I could be on the same side of the table, with Bill Seidman and Bill Clemmons, that would be wonderful. If you say, they're going to be on the other side of the table, then I'm a no-show because these are very skilled people at what they're doing.

There are others like that. You could put together a heck of a team. FDR used to call them dollar-a-year men. They won't even charge you a dollar. This can be handled.

Senator SARBANES. What is it you would do?

Mr. PEROT. You're asking Bill.

Mr. SEIDMAN. You're asking me?

Senator SARBANES. You just put the mantle on him, yes, and I am asking—what is it you would do?

Mr. SEIDMAN. You would do exactly what a bankruptcy court tries to do.

Senator SARBANES. No, I understand how a bankruptcy court works because it works within a statutory framework, everything is laid out, and you have a developed pattern on how you deal with these things. We do not have anything comparable on the international level.

Mr. SEIDMAN. We create it.

Senator SARBANES. Tell me just how you would do this. What is it you would do and how would it address what is asserted? Is——

Mr. SEIDMAN. I haven't accepted the job yet.

[Laughter.]

Senator SARBANES. I know, but Ross wants to put it on you and I just want to find out what it is you would do.

Mr. SEIDMAN. I'll tell you what somebody would do. They would go in, get the parties together, and they would say, here's the collateral that we've got. Here's the kind of help we can get from outside, if there is any.

Senator SARBANES. We're going to have outside help? I thought that was ruled out in the course of this discussion.

Mr. SEIDMAN. I haven't ruled it out because there are people that may want to help and I would certainly have them in if they want to help.

The point of the matter is that it has to be an agreement between the debtor and the creditor. Like any labor negotiator or baseball strike negotiator, you're going to get two parties together and try to make them see that they both lose if they don't make an agreement, and that is certainly going to be the case.

Senator SARBANES. What is the consequence if you take on that role and you're not able to get an agreement?

Mr. SEIDMAN. Then we get a better man to do it, but if——

Senator SARBANES. No, no. As you know, from our past dealings here in Congress, I have a lot of regard for you.

Mr. SEIDMAN. Thank you.

Senator SARBANES. But no one, I think, can guarantee that he can produce a result.

Mr. SEIDMAN. Absolutely not.

Senator SARBANES. Now, what is the consequence if the United States, in effect, makes you the point person to work out an agreement between the debtor and the creditors and you are not able to do that? Then what?

Mr. SEIDMAN. Then we'll go on in the status that we have now. The creditors won't get paid and the debtor won't be able to borrow any money anywhere. That will be the status and neither of them want that, so they will make an agreement.

Mr. PEROT. They'll make an agreement. You could make a great movie out of the agreement. It would take OJ off the front pages.

[Laughter.]

Because you're going to have everybody whining and posturing and running out of the room.

Senator SARBANES. I doubt very much anything will take OJ off the front pages.

Mr. PEROT. No, no. This would, because you'll get the sky is falling for 3 days. Bill, who's been around the horn 10 times in storms, will sit and listen to all that stuff. He understands it, whereas, everybody in Washington says, oh, my gosh. A Mexican just told me the sky is falling. The sky must be falling. We must act immediately and bankrupt our country. Give me a break.

Now, you go through all that stuff. It will settle down. These guys, on both sides, are smart. They want to get as much as they can. If they can get it from us tonight, wonderful. If they get it over time, with interest, they're going to be grinning and sitting around their country clubs talking about how shrewd they were. Either way.

The CHAIRMAN. Let me say, at this time, it is 12:50 p.m. and I want to thank both of our panelists, Mr. Seidman, not only for coming in today, but for your extraordinary work, and Ross Perot, for calling them the way you see them. We don't always agree, but you let people know where you're at.

I have to think that we should, and I like the word that Bill Seidman used, facilitate, not subsidize, an agreement. Obviously, we have an obligation. There are things that we can do.

To help facilitate and bring together the various parties and encourage the Mexicans to do that and to encourage a sounder monetary policy, I think, certainly, is something well within our capabilities.

I also have to go back to the prime conditions. If, indeed, the country is going to go to a free market system, then I think it's a sorry day when they turn back to another country, another sovereign, to pay off their obligations or to guarantee their obligations will be paid off—in this case, with hard-earned taxpayers' money from the United States.

I don't know how we can justify that kind of situation.

Now, obviously, the Administration is not going forward with this plan. If it goes through the back door and undertakes this with a $20 billion bailout by way of the Federal Reserve through the Treasury, I think it still should be held accountable to the people, as it relates to what conditions will be enforced, to see to it that the American taxpayers' exposure will be minimized.

Second, I certainly think, before you make an agreement, you have an obligation to see who will benefit, who will get these dollars, and whether you pay them off dollar for dollar. Are you going to give them their windfall, so to speak, and is that being done by the American taxpayers?

Is this something that flies in my face? I don't follow it. I don't follow the logic of it. Why are we bailing out private investors?

Mr. PEROT. Can I make one comment?

The CHAIRMAN. Certainly.

Mr. PEROT. Have you ever heard anyone specifically say, and every bank lending money would say, how are you going to pay the loan back? How will Mexico pay this back?

I don't think there's a single specific plan in writing that's been available to the House or Senate, so no matter who does it, they'll eventually have to pay it back with interest. There should be a plan, and that plan should pass scrutiny from very, very experienced and skilled financial and business people that say, yes, this makes sense.

They say we're going to go at 30 percent. That's a dream. It can't be a balloon plan. If they plan to pay it back before our Government takes the course that, as little as I know about it, we can't even think—no matter which pocket it comes out of, can we agree that the taxpayer is going to pick up the check if they don't?

Let's assume there is some trick that the White House can play to keep Congress away from it. The first question is, is that constitutional? The second question is, if it is, then do you have to tolerate it? Then, the third question is, when is this thing likely to hit the wall?

You'd better figure out how they're going to pay you back and plan ahead.

The CHAIRMAN. I've asked my staff and, regarding the first question, it would appear, initially, that they do have authorization. The Secretary of the Treasury does have the ability and the law is quite specific in stating that his decision can't even be questioned, subject to the approval of the President. The Fund is under the exclusive control of the Secretary and may not be used in a way that direct control and custody passes from the President and the Secretary. Decisions of the Secretary are final and may not be reviewed by another officer or employee.

So, it would appear that, pursuant to the Federal Reserve Act, they have this ability but, I think, Ross, your question, how will a pay-back be insured, is important. I think Senator Sarbanes would agree with that, as would most of my colleagues.

Mr. PEROT. Let's assume that, legally, they can do it—and I think that should get close scrutiny because everybody likes to run down the sidelines on legalities, so let's make sure that crosses the line—but, if that law does exist, I propose that you change it so

they can't keep doing it. I don't think it makes any sense at all to have a person not elected by the American people able to throw that kind of money around, unless you're at war or something like that.

This is not a crisis. It's a manufactured crisis. It's a Chicken Little problem and, then, how are they going to pay us back?

The CHAIRMAN. I think that's important. Will the plan work? How will they pay us back?

I want to thank both the panelists, Mr. Seidman, and you, Ross.

Mr. PEROT. Pleased to be with you.

Mr. SEIDMAN. Thank you.

The CHAIRMAN. Thanks so very much.

We're running late, so I'm going to ask our other panelists to come up and, if they could, summarize their testimony: Guillermo Calvo, David Mulford, and Rudi Dornbusch.

Senator SARBANES. Mr. Chairman, I'd like to note, because we ended the last panel on this subject, that the Exchange Stabilization Fund has been used repeatedly in our history to address instabilities in the exchange markets.

It is my understanding that, invariably, the use of the monies are repaid and we go on from there to address other situations as they arise.

This panel may be able to throw some light on that as well.

This is not a new thing and it is a time-tested technique which has been used by the United States to stabilize the markets, I think in lesser amounts than we are talking about here but, nevertheless, it is not some new trick or gimmick. It's been an established part of how we do business consistently now over a very long and extended period of time.

The CHAIRMAN. Gentlemen, given the nature of the hearing and how, I would acknowledge, it obviously has changed, I'm going to give you great latitude, No. 1, to summarize your testimony and, No. 2, to make any comments that you feel might be appropriate, given the situation as it exists.

I understand, Mr. Mulford, you have a time squeeze, so we're going to turn to you first, and if you have to leave, we understand that. We appreciate your being here with us.

OPENING STATEMENT OF DAVID C. MULFORD VICE CHAIRMAN, CS FIRST BOSTON INC. AND CHAIRMAN, CS FIRST BOSTON LTD., LONDON, ENGLAND

Mr. MULFORD. Thank you, Mr. Chairman. It's a pleasure to be here today.

I came today for the simple reason that I thought it was important to testify on the issue of assistance to Mexico, and I believed, because the Administration and the leadership of Congress had made a commitment to undertake such support, that it was important to do so. In other words, I think it's in our national interest to help restore confidence in Mexico, and particularly in its currency.

In my view, this fact transcends the many questions which I know are troubling Americans as to why Mexico got into this trouble: Why the devaluation was mishandled in Mexico, and why it was mishandled in the United States in the immediate aftermath,

as I believe it was. Because I think the United States and Mexico are bound together with important strategic, economic, cultural, and political interests, and that we face a situation in the world financial system which is clearly threatened by the kinds of events we've seen.

Having heard the developments today, I do think there's wisdom in going back to the drawing boards, because I did not wish to be in the position, as a former Under Secretary of the Treasury for International Affairs—where, you may remember, I served for 9 years as the Senior Economic Official in the Treasury during the difficult period of the 1980's with many of these kinds of problems. I thought that experience and also the fact that I've been 25 years in the world markets as an investment banker might be useful to you here today.

It is important, I think, as we look at this situation, to recognize that we have seen, in recent weeks, signs of the kind of world financial situation that causes deep concerns to those of us who have faith in the importance of maintaining a financial system that works. So, I'd like to submit my testimony for the record, even though it's, to some extent, dated by what's happened here today, and simply make a few observations.

First, I think we need to recognize, as has not been done this morning, that Mexico, over the past 10 years, has indeed implemented a program of impressive economic reforms, which has substantially restructured their economy and has increased our trade and investment with Mexico, which we were perfectly happy to see happen.

Many U.S. businesses have benefited from this. Many investors have benefited from this. Jobs have been created in the United States and I think that's an important point to bear in mind.

The second point I would make is that Mexico has succeeded, as have many other emerging countries in recent years, in attracting large direct flows of capital from around the world. Our world financial system operates today on that basis, as barriers have come down and capital flows have increased, because these countries have undertaken reforms that have attracted capital and helped them restore their economies and restore growth.

This is a completely different situation than existed in the late 1970's and the 1980's, when Mexico was heavily dependent on bank loans, was unable to meet its obligations, and the banks were trapped in Mexico. They put up a little more new money, but they were trapped, very effectively, for 7 or 8 years negotiating. These negotiations, we hear this morning, are supposed to be over in 3 days. Let's bear in mind, the last time it took 8 years.

Ultimately, the banks took losses. The U.S. Government did not itself take losses, and the situation was worked out. Mexico restored its economy. It attracted private capital, as we in the Government encouraged these countries for years to do, to make themselves attractive by reform, and the capital flowed to Mexico at an average rate of something like $14 billion annually over each of the last 4 years.

Returning countries like Mexico to private capital markets has been a primary objective. I'd like to point out that the flows of money were not speculative flows. They were flows of serious eq-

uity investment, direct strategic investment by corporations, and not simply short-term hot money flows of the type that have occupied our interest here today.

Indeed, many conservative institutions, leading institutions in the United States with fiduciary responsibilities to ordinary Americans in the form of pension funds and other institutions, have become investors in world markets. These institutions have to be regarded as serious investors, not speculators.

Now, why is the situation different in this case? The first thing is that, unlike 1982, when the banks were trapped and, ultimately, after a 9 year negotiation, took some losses, investors, in this case, have already taken their losses. They've been very seriously damaged immediately after the devaluation, and they've already taken their losses.

So there are huge losses, in the billions and billions of dollars, that are already in the system and that have been accepted by the investors. These are the investors, if we are to restore confidence in Mexico, not that we're trying to subsidize or give a good deal to. These are simply investors that we hope Mexico will be able to reengage, attract back as new investors, by restoring confidence.

Now, obviously, there are some very serious problems with regard to the so-called Tesobonos, because they're short-term debt outstanding, where there are people who would be paid if an arrangement were entered into. But, we mustn't think of this problem entirely in terms of the holders of the short-term debt, because there's a very, very large universe of investors involved.

Why should we act, and who benefits? If there were to be guarantees—and, personally, I have doubts about that but, having had the President say we would provide support, and having had the leadership of Congress support that——

The CHAIRMAN. Would you mind telling me why you have doubts as to that?

Mr. MULFORD. I think you said, one doesn't want to get into the business, when you're not sitting in the Treasury seat any more, of second-guessing what people are doing. It seems to me that was a plan that was brought up relatively quickly, and I think the point was made, without a lot of in-depth work and perhaps understanding.

So, it was perhaps a difficult plan to execute, as we've seen subsequently trying to move this through Congress. It's a very complicated process, but it is important that we support Mexico and that a plan be developed to do so.

Now, who benefits from assistance to Mexico? The Mexican economy benefits, the United States economy benefits, and I don't need to go through all of our mutual interests with Mexico. Those have been well-covered today. Wall Street or individual investors don't benefit. As I've said, they've already taken their losses in many, many cases, and they've paid a high cost for that.

I can answer questions later, if you wish, about how this crisis developed but, perhaps to be short in my comments, I should turn to what the key issues are now to solve this problem.

The first thing that has to be done is, there has to be a restoration of confidence in Mexico and its currency. This is a process that begins at home in Mexico, just as it did in the 1980's throughout

Latin America. True reform came out of the political process in those countries. That's what has to happen first.

There has to be a strong and stable currency. Clear macroeconomic targets are essential in reestablishing Mexico's credibility. Pure austerity, endless austerity, won't work if it's not accompanied by a solution to the short-term liquidity problem that is faced and supported by unquestioned monetary discipline.

Now, a number of people in world markets—and I'm not now expressing my opinion, because we're talking here about recapturing world confidence, individual investors, not a few bankers as was true in the 1980's, when you had a handful of bankers who were key players. These were thousands of individual investment decisionmakers, who have to be recovered in their confidence.

A lot of those people would say the only way to recover confidence in Mexico's currency today is to establish, in effect, a gold standard-type system, or a currency board as it's called, which has been implemented successfully in other countries. This is a system that would provide automatic and unquestioned monetary discipline, and therefore re-create confidence.

I'm not sure you have to go that far, but it's clear it isn't good enough to just say, we're going to do a better job. There has to be a very clear indication as to how monetary stability is going to be maintained.

The CHAIRMAN. A move to the gold standard?

Mr. MULFORD. The currency board operates with some of the same features of the automatic adjustment mechanism.

Now, the second thing that needs to happen is that there needs to be an agenda for reform, again, in Mexico, that captures the imagination of world investors. That agenda, in my opinion, must include an aggressive and imaginative privatization program to continue the restructuring of Mexico's economy, which has not yet been completed, to put more assets on the table for privatization.

This will, in my opinion, if you are aggressive enough and put all the assets out in an orderly fashion, attract capital and will promote sustainable growth once again in Mexico. We should make that an important part of our request.

Obviously, Mexico has to decide these issues. If they want to recapture world market confidence—not this Committee, not the Treasury, not the Administration, not even the IMF—since there's not enough money in the world, in governments or in the IMF, to finance endlessly a problem of this type, there has to be a resurrection of the kind of capital flows of a private nature that we've seen operating in recent years.

So, Mr. Chairman, I came here today in support of assisting Mexico. The program is now changed. I think you'll find that the Exchange Stabilization Fund, which I'm well acquainted with, is an instrument which has been created under law to provide the United States with the kind of rapid ability it needs to move in crisis situations. That has been, as Senator Sarbanes has referred to—and we've had dealings on this in the past between us when I was in office—it has been used very effectively, very conservatively, and very cautiously, to address certain world financial threats, as was true in the 1980's with the LDC debt crisis.

There is, I believe, a congressional oversight provision in that legislation where, after 60 or 90 days—I don't remember the exact period—the Exchange Stabilization Fund reports its activities to Congress. Those are reviewed. There's probably a report in your files now, 60 or 90 days old, of exactly the position in the Stabilization Fund.

So, it's not an instrument that needs to create the impression that Congress is being circumvented, because it is a good instrument for issues of this type. I say this because one of the difficulties with the congressional process is that it takes time. All of the issues that have been raised this morning are perfectly appropriate issues to be aired by the U.S. public, taxpayers, and by Members of Congress over important decisions like this.

We are in a situation where markets are declining sharply, not just in Mexico, but in many, many other countries. It is not impossible that we could see developing a serious world market situation of the type that nobody would be able to correct if the issues are not addressed in an orderly way that restores confidence.

So, it's not just a Mexican problem. I think we need to bear that in mind. It is in the interest of the United States in maintaining our economic development, our growth, our standard of living, and financial orderliness in markets, that we should address and help with this problem. Obviously, we are being joined around the world by other countries and by the IMF with that purpose in mind.

As I said, concluding my testimony, there were four points that I wanted to make at the end.

One, that the President and the leadership of Congress pledged the support of the United States. Once that's done, if that isn't forthcoming, then the lack of that support being translated into action becomes itself a market force, and adds to the chaos and to the decline in markets.

Second, support will help restore investor confidence in Mexico and prevent Mexico's liquidity problems from spreading to other emerging markets. I think that's very important for the United States. We have trade all over the world, and relations with these other countries.

Third, the support will halt a free-fall of the peso and a collapse of the Mexican economy, thereby limiting economic and political fallout for the United States. Let's remember the 1980's, when some of the facile comments made by people here this morning are looked into in some detail.

The workout of the LDC debt problem took 8 or 9 years and, if you look at Mexico in particular, was accompanied by a period of 8 years of recession, high unemployment, high inflation, and a demoralized economy. That was true in other parts of Latin America and was a problem for the United States.

One of the sources of the immigration problem, if you go back to the 1980's, was that very long period of economic difficulty in Mexico. So, the last 4 or 5 years after the recovery of the debt problem has been a period of growth in Latin America, and the United States has enjoyed that recovery in the form of exports and investments all through the region as we've seen our neighbors rise together and restore their economies. It's very important that we keep that process in this hemisphere alive, in my opinion.

Finally, I believe that, between the Mexican government, the U.S. Administration, and Congress, a program can be designed which will involve no substantial cost to the U.S. taxpayer.

On balance, therefore, once a proper structure is set up, the benefits to the United States, in my opinion, should clearly outweigh the potential risks.

Thank you very much.

The CHAIRMAN. Thank you very much, Mr. Mulford. I think your observations are very illuminating. If you have time, I might pose one or two questions.

Mr. MULFORD. Certainly. I'll stay as long as you need me.

The CHAIRMAN. Mr. Dornbusch.

OPENING STATEMENT OF RUDI DORNBUSCH, Ph.D. FORD INTERNATIONAL PROFESSOR OF ECONOMICS, MASSACHUSETTS INSTITUTE OF TECHNOLOGY, CAMBRIDGE, MA

Mr. DORNBUSCH. Thank you, Mr. Chairman. I'd like to briefly develop what happened in Mexico, to ask why a market cannot solve the problem now, and what to expect from the new initiative.

The events in Mexico over the past 3 years are very simple. The currency was systematically overvalued in an attempt to bring down the inflation rate. Year after year, depreciation fell short of inflation. The more and more overvalued currency made for high interest rates.

In the runup to the election, with political difficulties, the government made extraordinary mistakes. First, in shortening radically the maturity of the debt, then in dollarizing it, and then in running off $30 billion in reserves, till we were left just before Christmas with no money, no plan, no idea, no expertise, and no competence. That's what we've seen as the extraordinary fallout.

The immediate question—whether this is a liquidity problem only, created by the very poor debt management and reserve use in the past year, or whether there is a deeper solvency problem—that question is important in asking whether restructuring is totally essential, a foregone conclusion, or whether at all one wants to entertain the possibility of maintaining the debts, letting them run off, and restructuring.

The market can't solve immediately the problem, because nobody knows what will happen in Mexico, what the exchange rate will be, what the politics will be, how much is owed, and how far the Mexican government is willing to go in implementing policies.

In part, that uncertainty comes from a Mexican political process that relies on arcane pacto-agreements. These agreements are running behind the facts, to a very significant extent, and limit the ability of the government to make a credible commitment to investors.

Interest rates are 50 percent, and will not attract investors, because they have never anywhere been paid. A rock-bottom low peso is not persuasive, because that's the front door to inflation, and that would not persuade investors.

So, everybody in the financial markets is like two Germans standing at the door saying, "After you." In the meantime, there is a meltdown.

What can be done? The loan guarantee program was an effective program, putting Mexico back in the market, and with that, a market-based lengthening of maturities, a moderation of interest rates, and, therefore, a return to normality on the assumption that there was a liquidity problem, that Mexico had debts that were sufficiently moderate that it could carry them, and that it had enough economic and political stability to make that plausible.

I think that basis is still there today but, of course, the loan guarantees are gone, and with that comes the next set of issues.

First, whether in fact there is enough of an assistance package available from the Exchange Stabilization Fund—which, of course, cannot be totally committed to Mexico, because it might not be paid back. Finding an extra $10 billion in the IMF is possible, but it creates the precedent of a new bailout facility and, surely, Italy must already be interested in it and voting for it.

Where the money in the World Bank comes from, I'm not aware. It would certainly be short-term money, and it would be rushed in as much as the previous program, so it's therefore important that one ask what precedent is created. It's undesirable to create a precedent.

Second, what conditions are imposed? I think the conditions on Mexico of any arrangement ought to be immensely stringent; that there ought to be a budget surplus, including even higher interest rates, and that it is important to have a highly competitive peso to produce a current accounts surplus in Mexico that reduces the exposure to external debt over time, and creates for Mexico a more normal growth rather than a debt-based one.

I think there ought to be far more effective supervision, since it is clear that, in the Mexican political system, smoke and mirrors in economics are totally dominant, and that it is hard for our Administration to say "no" when that goes on, as it did in the past year.

I think it is also essential that Pemex be privatized. I think it's a disgrace that the Mexicans should rather wish to default than privatize a state enterprise which everybody knows is stealing money from everybody—from every Mexican worker and from the Mexican government. That we should be sensitive to their political difficulties, I think, is pushing things.

If the IMF is involved, that is a particularly auspicious forum, or the World Bank, to raise that issue, so we do not have to do it.

In summary, where do we stand? Mexico has a liquidity problem that comes from disastrously poor debt management. Those debts are payable if there is a mechanism that restores the market for Mexican debt. That market can be restored with short-term and medium-term support, but even more so with a credible Mexican program that is very effective and that includes privatization, including of Pemex. That puts enough money on the table to be reasonable.

I think it's time for Mexico to accept more interference in its economic policies, since coming regularly with debt defaults really doesn't make a good impression.

Thank you.

The CHAIRMAN. First of all, before I call on Dr. Calvo, let me apologize for not having again properly introduced the panel.

David Mulford, who has testified, in addition to being Chairman of First Boston Europe, holds a B.A. in economics from Lawrence University, an M.A. in political science from Boston University, and a Ph.D. in philosophy from Oxford. He was Under Secretary and Assistant Secretary of State, serving a distinguished role from 1984 to 1992.

Dr. Rudi Dornbusch is currently the Ford International Professor of Economics at MIT. He's previously taught at the University of Chicago and the University of Rochester. He's been at MIT since 1975. He holds a Ph.D. in economics from the University of Chicago.

I'm going to call upon Dr. Calvo now. He is a professor of economics and the Director of the Center for International Economics at the University of Maryland. He previously was the senior advisor at the research department of the International Monetary Fund and a professor of economics at the Universities of Pennsylvania and Columbia.

Dr. Calvo.

OPENING STATEMENT OF GUILLERMO A. CALVO, Ph.D. DIRECTOR, CENTER FOR INTERNATIONAL ECONOMICS, UNIVERSITY OF MARYLAND

Mr. CALVO. Thank you very much, Mr. Chairman.

The CHAIRMAN. By the way, I wish some of our colleagues were here because I think on balance, in terms of how you have placed this, you have put a perspective that would be very beneficial if the rest of our colleagues could get a sense of it. Maybe they already know it.

Dr. Calvo.

Mr. CALVO. Thank you very much, Mr. Chairman.

It's, for me, a great honor to be here. I should say that I am a national from Argentina, although I've lived in this country for over 20 years, and teaching, as you just recounted, in several American universities.

Now, I guess a key issue that comes to mind—we have covered a lot of ground so far, so I'm not going to repeat much of what was said. There still remains a question about why is it that, maybe 1 or 2 months ago, everybody was talking about Mexico being a success story and now, all of a sudden, we go back to the kind of expressions that we used after 1982.

So, what happens with Mexico? Is there a structural break somewhere in the ship, or is it simply a financial strain we are seeing?

I guess those who would support the notion of the defunct rescue package had the idea that it was essentially a financial problem. All you needed was some credibility being put into the system, and then the wheels would turn again. I think that's the theory behind it.

Now, why is it that you have to all of a sudden come to the rescue of a neighbor when it was doing so well before? Some of us have been looking at Mexico before, and we noticed that there was a dramatic increase in short-term debt instruments. In addition, there was a dramatic increase in money. We have been talking about that, and I have a picture that—I don't know if you can see it from there.

Here you have the growth, the stock of money, and here is international reserves. Now, Mexico ran a system which, at the end, was very close to being a fixed exchange rate system. It was being pegged completely to the dollar. It was like being, actually, New Jersey, which was mentioned today in connection with Mexico in terms of output, because there was a fixed exchange rate, but there was this big gap between money and the backing of money. So, what you started to see during the year—and on the picture that doesn't show, I will explain why—is that this money started to fall. People wanted out. They saw the risk of devaluation, and started to take the deposits out of the system.

In order to prevent a crisis—and that's why you don't see this going down—what the central bank did was to begin a bailout. Perhaps I shouldn't call it a bailout, but to solve the liquidity problem of banks by issuing more liquidity. That's a normal reaction from a central bank. A central bank here would do the same thing, but there is a big difference. Mexico cannot print dollars, and we here can. So you can do that to the extent that you have reserves.

What happened in the meantime is that the money was being pumped in. People took the pesos, exchanged it for dollars, and reserves started to go down. So it went down from the numbers which we see here, which is about $25 billion, to reportedly $6 billion before the crash.

At that point, you still have this big mountain of money basically, plus the big mountain of Tesobonos. A sense of crisis develops, and everybody wants out. Of course, there is not enough money, so they decide to devalue.

Now, we can discuss whether that was a good idea, how it was done, et cetera, but that's how I see the process developing. It's very short-term liquid obligations that are looking for the dollars which are unavailable and, if everybody does it, then the system breaks.

That's why, first of all, the business in Mexico, it seems to me, is to reschedule debt. To do that, in the middle of the crisis, it's very difficult for Mexico to come up and say:

> Look, I made a mess of it. Now I'm going to tell you, in the next 10 years, I'm going to do things much better.

That's not credible. Certainly, it's not credible, it needs the help of a friend and that's how I see the role of the United States.

We've seen, today, that that notion, or that project, has been watered down. We are including other institutions. Now, we talk about the World Bank, we talk about the IMF, but this is no different from the United States. The United States is a member, a dominant and important member, of the IMF, and an important member of the Fund. So the United States is going to be involved, and the credibility will hang very strongly on the United States.

I don't want to take a lot more of your time because it's already late, but let me point out that, here, it's all right to reschedule but this rescheduling implies that these funds could be used very quickly. It's different with the loan guarantees, for example, that were given to a country like Israel, because those funds were to be spent slowly, over time, on projects that you can look back and say, "Did they do it or not?"

So, there was some checking. If they squandered the money, there was some way to stop and at least cut the hemorrhage. Here, the rescheduling of the Tesobonos—$28 billion—maybe the money has to be used in the course of next year. You have to establish a conditionality.

That's why the concept of collateral is necessary. Otherwise, you just look back and say, "You didn't do it. I'll stop giving you the money." That's why you need the collateral.

Now, how to establish the collateral. I was very baffled in thinking about what to say to this Committee, how to think about the collateral, and how to judge what the Administration had in mind because, as was said repeatedly today, the collateral is not well defined, and it's a key piece.

If you activate the collateral when you are at the end of the road, and the Mexicans cannot pay their debt because people would be starving in the streets, that would be a very tricky thing to do, a very politically-charged thing to do, to say to the United States, "Now, I have bad news for you. I'm going to take the money that you were receiving for the oil, and I'm not giving it to you."

That's very, very difficult. I would suggest—and this is just a suggestion—that perhaps one should think about precautionary collateral. Start collecting from the Mexicans and setting up a fund before there is actually a crisis and, of course, one could develop a formula for that to happen.

Now, to end, I think from the point of view of the United States, it's very hard to evaluate the impact that it would have on trade. It's clear that the impact on illegal immigration could be very large. I wasn't just playing with some numbers.

If you take the exchange rate provision yesterday, the dollar wage, which, as Mr. Perot showed to us, was already low, it would already be 60 percent of that now. It could get much worse.

We are looking at an exchange rate of 6. If the United States doesn't come to the rescue, the exchange rate could go up to 9. I'm not pulling that out of the air. I came up with these numbers by looking back at what happened in 1982. In 1982, there was a crisis like this, and nobody came to the rescue at the time.

The expenditure and the devaluation that took place then is equivalent to raising the exchange rate to 9 now. That would be catastrophic because the lure of going to the north would be very difficult for anybody down there to resist.

I think it's very serious. It has to be a stabilized situation. The program is going in the right direction, but we should make sure that these monies are not being spent, and then, as it was said—and I believe it's a real concern—after 6 months' time, 1 year's time, we come back to this table and say, "Well, we still have a problem. It was not $40 billion, it was $80 billion," and so on.

Thank you very much.

The CHAIRMAN. Thank you very much, Doctor.

Mr. Mulford, let me ask you this. In your view, did the Administration ignore signs of the imminent collapse of the peso? Were there clear warning signals? If so, what could they have done?

Mr. MULFORD. Mr. Chairman, I don't know the answer to that because I'm not inside the Treasury. I can't really answer the question.

I can make an observation, which is that, as I think has already been indicated here by other experts, there were signs of a growing problem with regard to the currency. That's point one. Those signs were evident to a number of people 3 or 4 months before the event. However, we have to remember that Mexico has a new central bank regime and has not followed policies of full transparency, the way many other countries do, so that reserve figures and other data from the central bank, for example, I believe are only published three times a year instead of monthly or weekly. They're now willing to correct that, but not everybody had the information. So that's the first point.

The second point is that there could be economists in the Treasury, or elsewhere in the Administration, who thought that devaluation was the right solution to the problem. I don't happen to share that view, but maybe they did. I think you'd have to ask them that question.

Third, clearly, when the devaluation took place, it was very badly handled by all parties. The Mexican government has certainly acknowledged this and have appointed a new minister. He's a very solid minister and is now handling the situation—Mr. Guillermo Ortiz.

At the time of the devaluation, it was handled badly, but I don't think the response outside of Mexico was particularly impressive, either.

I don't know what my colleagues here, who are economists, would have to say but it's possible that if Mexico had developed an austerity package and a plan and had come out with that kind of a plan, which is now being discussed, earlier, with a modest adjustment of the currency being part of that plan, probably world financial markets would have accepted it.

It wouldn't have had this catastrophic effect of just dumping the devaluation out from one day to the next, and then the next day floating the currency.

The CHAIRMAN. By the way, that happens to be at the heart of some of the questions that the Senators were posing, Senator Mack and others. I thought they were good questions.

Treasury obviously wasn't here at a level to answer, because it's a very real question that's been written about, and that is whether or not there were officials at Treasury who encouraged this devaluation, and to what extent.

I think that's appropriate and I think the Administration has to come forth—we're not looking for sacrificial lambs—and explain in some detail what its role was. I mean, here you are, looking for whether it's $20 billion, $40 billion. It's a problem we have to deal with. I think the people are entitled, and Congress is entitled, to know what did you know, when did you know it, and what did you do.

Mr. MULFORD. I think those are appropriate questions to be asked and I think, if you were to engage Mexican officials, you would find that there were some Mexican officials who, along about September or October, felt that some adjustment in the currency might be the right thing to do but, obviously, their view was that, if that were done, it would be done within the context of an adjustment to the total economic program.

As I said, the problem is how it was done, with an insensitivity to global markets. It broke confidence in global markets among investors who had been supporting Mexico in the form of equity, strategic investment, et cetera. Not just short-term hot money people, but serious investors.

The CHAIRMAN. Dr. Dornbusch, you suggest that all of the symptoms of a troubled financial system were in place before the devaluation occurred. Do you believe that Treasury was aware of those problems?

Mr. DORNBUSCH. I certainly believe that Treasury had been monitoring Mexico for quite awhile, as they monitor all countries that have significant real appreciation, gigantic current account deficits, and significant shortening of the debt.

I don't believe on the eve of a Mexican election was a very good time to get something done. So one actually has to go back and ask why, in 1993 and early 1994, when President Salinas was in power and had extraordinary legitimacy from his performance to do something—why wasn't it done then?

I wouldn't really have left it for the tail-end of the year, when there was no money left and when nothing could be done anymore. Certainly, Secretary Bentsen must have had conversations. He was the Special Ambassador to Mexico. Was devaluation part of that? I'm not aware.

The CHAIRMAN. Dr. Calvo, you, in an article in the New York Times some time ago, almost predicted this situation. You pointed out that there was a regular devaluation after each election. Isn't that true?

Mr. CALVO. In my article I was concerned that if you did the devaluation in a unilateral way, a way that was seen as an arbitrary measure by investors, you could cause a stampede and that there was, as I pointed out before, enough short-term liquidity out there that it could start running against Mexico, could break the bank in Mexico, and could really make a big crisis of the devaluation.

So, at the time, I suggested that this was, in fact, something that came out in the Brookings papers. I suggested that Mexico should start talking seriously with its NAFTA partners to establish some kind of a fund in case something like this developed. It just coincided with the time when this fund of about $6 or $8 billion was set up in the context of NAFTA.

I pointed out in the paper, though, that those amounts were going in the right direction, but seemed to still be small given the magnitude of the problem.

The CHAIRMAN. Let me ask Mr. Mulford and the rest of you just one last question.

Let's suppose we've come up with the right amount of money to deal with the immediate cash-flow problem. Absent there being significant reform in the system, whether by establishing a truly independent bank or guaranteeing that you're not going to have the printing presses printing more money, is this going to work, or will we be back 2 years from now, or 6 years from now?

Mr. MULFORD. I think if the right policies are put into place in Mexico, if you look back over the last 5 to 8 years, I think you have to say that Mexico, on balance, followed many, many credible policies. It did a good job managing and restructuring its economy.

It got into difficulty recently, as has been described, but I think it's possible to obtain the kinds of commitments and policies in Mexico necessary to a successful assistance package.

It is, however, something that doesn't happen by itself. You've got to work at it if you're an official outside government, in the IMF, with the BIS, or whatever and, in Mexico, it is a major exercise that has to be done in a credible way.

The difference this time, and it's an important difference from the 1980's, is that in the 1980's, you remember, policies were addressed. Then, a group of commercial banks, maybe 25, on the Steering Committee would look those policies over. The IMF would look them over, the World Bank would look them over, and the banks were stuck in there. They could not withdraw.

We could come to a judgment that the IMF was in charge of conditionality, et cetera, et cetera. The Treasury, obviously, worked with them in those days, too.

These days, the investors that need their confidence restored are hundreds, thousands of investors all over the world making different kinds of investments—not just making loans, but making equity investments, strategic investments, et cetera. This is a much more diffuse universe of investors in today's modern global markets that needs to be impressed and addressed.

That's why the assistance package, whatever form that takes, has to be done with an eye on the policies of Mexico, and an eye on the realities of the markets. Those two issues have to be joined together in a way that's credible if it's going to work.

The CHAIRMAN. Dr. Dornbusch.

Mr. DORNBUSCH. Any package for Mexico, of course, has to ask for monetary and fiscal policies. On the monetary side, it's clear that having a Mexican notion of an independent central bank isn't enough. Something far more significant should be put in place, whether it's a Bundesbank-type structure that, in effect, is decisively independent of the government, or a currency board—either one is good enough, but it has to be something different from what is now in place.

On the fiscal side, clearly, a budget surplus is necessary to give confidence. But neither of those issues resolves the question of how the debt is going to be paid.

There are three options. One is to say, with regard to this support package, let's see whether it works. I think that is a poor direction to go because, if the U.S. underwrites it, we ought to have a better idea at the beginning whether it will work or not.

The second is to immediately restructure debt. That is dangerous because there will be a fallout for other economies, like Argentina, where very liquid CD's are being rolled by the banking system.

The third is to tell Mexico that privatization of a significant asset has to be made in order to put something behind the runup in debts that is taking place. Pemex is worth some $50 billion, and the timetable for privatization would really be all that is necessary to solve this big liquidity problem.

Anything short of that, the United States and the IMF can really not do. They cannot do an independent central bank, cannot pay debt, and the budget surplus isn't going to be large enough to pony up $30 or $40 billion.

So, in the end, Mexico has to bring something very new, in addition to discipline, to the table. The only thing I see is significant privatization of something as transparent as Pemex.

The CHAIRMAN. Dr. Calvo, do you care to comment?

Mr. CALVO. I fully agree with the previous comments.

Just to illustrate, the Mexican central bank—this sharp spike here, this is 1994. This is what the central bank did when there was a bit of pressure in the banking system. These are loans to the banking system. It went up by about $5 billion in a matter of months. That's how they lost their reserves, and this is an independent central bank.

So, I fully agree with Rudi and David that this has to be done in a credible manner. The markets are very nervous and quick, and you have to convince them. Besides, you have to realize that they are now going into a phase where it's possible—there is very likely to be a recession.

Undoubtedly, expenditure and consumption will fall, and tax revenue will fall. So, having a surplus in that context is going to be very, very tough.

The CHAIRMAN. Let me ask you one last question, and I promise this will be the last.

I have been reluctant—and I'm not generally reluctant as it relates to most things—but I have been reluctant to put this on the table. I do not mean to question another sovereign nation and its capacity. We can question our own capacity, whether we have the political wherewithal but, do you believe that the Mexican government has the political wherewithal? Is there sufficient stability for it to undertake the kinds of changes that the three of you have suggested? Is it realistic?

Because, I have to tell you, from what I've gathered from your testimony and others', and from speaking to others, it strikes me that that's a very real question. We were led to believe that Mexico was really stabile. We see in graphic illustrations, not only with the uprising in the south or with some of the indigenous Indians but in other areas, that there really appears to be a question regarding stability.

Now, by just raising that question, we begin to maybe tread on people's toes or begin to create some problems but, if I have to be so concerned about just raising that, it would seem to me that there is some very real question.

Mr. Mulford, you've been dealing with this situation over the years. You're an international expert. Is it unreasonable for me to put that forth and to suggest that maybe there is not that kind of stability necessary to bring about the kinds of reforms and conditions necessary to change the pattern of doing business there?

Mr. MULFORD. When you look at how these problems came about and why there wasn't action taken earlier, as suggested by Rudi, I think you have to look at the fact that, in Mexico, there were political developments that unsettled the seat a bit, whether it was Chiapas, or the assassination of Mr. Colosio, and so on. Then, of course, there was the election itself, which is a major event in Mexico. So it's perhaps understandable that the confluence of those kind of events caused a situation where they didn't take action as early as, perhaps, they should have, even after the election.

Of course, one has to remember this is a new government in its early days. So it's very important not to make premature judgments.

My view is that the political establishment in Mexico, and the people who are in the government today who are experienced government people, have the capabilities—and the system has the stability—to address these problems. However, I do think it's important that there should be a strong demonstration of the new President's authority in these matters, and in the government's own approach to these matters, so that the world sees that statement of authority and gets the message that this is a government that's in charge.

Because it's in its early days, this hasn't come out perhaps as clearly as it should have. I have no doubt that it's there. They're capable, and I think if they get that message out they will succeed.

The CHAIRMAN. Rudi, I see you're nodding your head.

Mr. DORNBUSCH. I think that the Mexican government has the technical competence. They have lost their legitimacy, which in the past was based on superior economic performance. That clearly hasn't been the case.

So the Mexican President has to make a show, but what show is he going to make?

I come, again, to the same point. If he puts on the table some assets that avoid a very deep and long recession in Mexico, he'll do the best for politics, for the Mexican economic performance, and for an early return of capital. If he fails to do that, then the recession that will come will unravel Mexican politics, without any question.

In Mexico, they say Pemex is politically impossible. We know around the world that's a stupid thing to say. If there is now an opportunity, then it ought to be used and it ought to be possible to explain that privatization is far preferable for the average and the poor Mexican to a long recession once again, as in 1982.

We are back to 1982. The only question is how to come out of it.

The CHAIRMAN. Dr. Calvo.

Mr. CALVO. I guess an important difference with 1982 is that the PRI is not as strong as it used to be. These people have to regain their credibility, and in a much tougher atmosphere.

I think, however, that there is no option for economic stability and economic health. The alternative will mean a collapse of the political equilibrium as we know it.

So, from the point of view of the United States, I see that, even though there may be risks, helping Mexico go into a stabilization program as soon as possible is of great importance.

The CHAIRMAN. I want to thank the members of this panel, all of you, particularly for your patience. It's after 2 p.m. Again, we owe you a deep debt of gratitude.

This Committee stands in recess.

[Whereupon, at 2:05 p.m., the hearing in the above-entitled matter was concluded.]

[Prepared statements and additional material supplied for the record follow:]

PREPARED STATEMENT OF CHAIRMAN ALFONSE M. D'AMATO

I would like to welcome our distinguished witnesses from the Federal Reserve, the Administration, academia, and the private sector. Today's hearing concerns the Mexican peso crisis and the Administration's proposed $40 billion loan guarantee program for Mexico.

Never before in our Nation's history has a President taken the extraordinary step of asking Congress to approve a loan guarantee package of $40 billion. This is four times the size of the loan guarantees we approved for Israel in 1992, and 25 times the size of the loan guarantees we approved for Chrysler and New York City in the late 1970's.

The Administration has painted all sorts of doomsday scenarios to justify $40 billion in loan guarantees for Mexico—severe U.S. job losses, 500,000 more illegal immigrants, and stock market crashes around the world.

But Congress must not be bullied into approving $40 billion in loan guarantees for Mexico. We must protect American taxpayers.

Right now, I have grave reservations about the Administration's proposal. I have four basic questions.

First, how did we get into this crisis?

The Administration now claims that it was taken by surprise when, on December 20, 1994, Mexico set off the present crisis by devaluing the peso, but the signs of serious trouble in Mexico were clearly present months ago:

- two assassinations;
- rebellions in the south;
- easy money;
- too much short-term debt;
- a large trade deficit; and
- an excessive reliance on highly liquid foreign capital that could—and did—leave Mexico at a moment's notice.

Who in the Administration was watching Mexico? What did the Administration know about Mexico and when did it know it? Why didn't the Administration raise a red flag before December 20?

Why wasn't there more consultation between the Administration and Mexico? Why wasn't Congress consulted sooner? What role did the Administration's inaction or silence play in bringing about this crisis? Did the Administration advise Mexico to devalue the peso? Could the peso's crash landing have been softer?

Second, will $40 billion in loan guarantees solve Mexico's crisis?

The long-standing Mexican ruling party—the PRI—won reelection last year by following an inflationary monetary policy. Isn't a U.S. bailout simply a quick fix? Won't Mexico be back asking for more guarantees in a few years?

The issuance of U.S. guarantees without a change in Mexican monetary policy will result simply in the use of American taxpayers' dollars to mop up surplus pesos being printed by the Mexican central bank. Because Tesobono bonds must be paid back in pesos but are pegged to the dollar, the Mexican government's obligations have soared since the devaluation.

The cure for Mexico's crisis is in Mexico City, not Washington. The Mexican government must adopt a tight monetary policy. Mexico must privatize state-owned monopolies and abolish wage and price controls. Mexico must reform its one-party political system.

I am concerned that $40 billion in loan guarantees will draw the United States into a deeper and more intrusive relationship with Mexico. Won't this inflame anti-American feelings in Mexico? What if Mexico defaults on U.S.-guaranteed securities? No one is more unpopular than the banker who forecloses on the family home or farm.

Third, why should American taxpayers bail out speculators in risky Mexican securities?

These speculators gambled for big profits and now must live with the consequences. Mexican Tesobonos pay almost 20 percent interest; an FDIC-insured bank account pays a little over 5 percent.

What kind of a precedent will we set if we bail out Mexico? What if another country has trouble? The United States cannot afford to be the world's banker.

In the long run, enforcing market discipline will benefit the United States and global economies. If speculators are bailed out now, they will make even riskier investments in the future with more serious consequences. Speculators must accept the fact that emerging market investments are not as secure as insured savings accounts.

Fourth, and most importantly, what is the risk to American taxpayers of a default by Mexico on $40 billion in U.S.-guaranteed securities?

The Administration assumes that Mexico will pay off its debt, but U.S. banks were left holding the bag in 1982 when Mexico could not make good on its debts.

The Administration has asked American taxpayers to guarantee $40 billion in Mexican debt with a maturity of up to 10 years. Once the President has issued these guarantees—no later than June 30, 1996—what leverage will the United States have to make sure that Mexico lives up to its promises over the next 8½ years?

The President was authorized to issue loan guarantees to Israel over a 4- to 5-year period; the Chrysler loan guarantee board was authorized to issue guarantees over a 4-year period; and the Treasury Secretary was authorized to issue guarantees for New York City loans over a 4-year period. Expanding the timeframe for the issuance of the Mexican guarantees would increase the United States' ability to ensure Mexico's compliance with any economic or political commitments they make.

The Administration claims that "assured" sources of repayment exist. But if assured sources of repayment really existed, banks and private investors would provide the funds necessary to support Mexico's short-term debt.

The Administration relies solely on a security mechanism whereby non-Mexican customers of Mexican oil will pay for such oil through the New York Fed. But this mechanism will not protect American taxpayers.

In the event of a default, Mexico could stop selling oil to non-Mexican customers or Mexico could sell oil to non-Mexican customers who refuse to make payments through the New York Fed. Congress demanded more collateral from New York City and Chrysler.

In sum, I believe the Administration is asking American taxpayers to bail out a badly run Mexican government. Before putting American taxpayers on the hook for $40 billion, we must demand that the Administration make a far stronger case than it has so far. We must consider alternatives. Why can't Mexico renegotiate its debt? We must protect American taxpayers.

PREPARED STATEMENT OF SENATOR RICHARD C. SHELBY

Mr. Chairman, I want to thank you for scheduling today's hearing.

Only by exposing this proposed $40 billion loan guarantee to public scrutiny can we properly make a judgment on behalf of the American people whether such a show of "confidence" in the Mexican economy is in *our*—the United States'—vital, national interest.

It seems the more you look at this loan guarantee package and the more you come to understand the details, the more questions you have about its purpose and effectiveness, the more questions you have about why we are doing it and why we are the only ones who can do it, and the more questions you have about who really benefits and who really loses on this deal.

While securing Mexican short-term debt against default is certainly the immediate function of this package, there appears to be a consensus that this is a problem of confidence, a crisis of confidence, that continues to compel additional U.S. financial support for Mexico.

I agree that Mexico is suffering from a crisis of confidence in its capital markets—I am just not sure that I agree that the United States can solve this problem, and particularly, that this package will do much more than cover short-term losses without ever realizing the promised benefit of long-term stability in Mexico and the international marketplace.

It is argued that we must underwrite existing multi-billion dollar Mexican short-term debt in order to shore up international investor confidence in Mexico's economy. That if we do not, we could suffer an international crisis, starting right here in the United States—with the loss of hundreds of thousands of jobs, possible institutional failures, and domino theory insecurity in our financial markets.

Renewed confidence, it is said, will minimize such losses and so we, the United States, need to assure the rest of the international community that Mexico continues to be a viable going concern worthy of investment.

Insuring the Mexican government against default on $40 billion, $25 billion, or $10 billion worth of short-term debt doesn't solve the crisis of confidence in my view. Covering these losses, whether they are ever repaid or not, may provide sufficient liquidity for the Mexican government to borrow more and meet short-term international obligations, but it does not instill *confidence* in investors that Mexico will continue to be a viable market worthy of investment.

Only by adopting and following tight, anti-inflationary policies, by securing Mexico's "independent" central bank against political influence to print more money, and by committing themselves to a responsible, coherent, and transparent economic policy will Mexico achieve the kind of confidence that it requires to regain economic and financial stability.

This, in my view, is the key to Mexico's economic future—not $40 billion in loan guarantees, not a "show" of U.S. support through insurance gimmicks. Ironically, without these necessary internal checks and balances, even $40 billion won't be enough in the long haul.

The United States has already committed close to $20 billion through swap agreements and IMF lines of credit. How much more will it take to make a difference and why will a loan guarantee solve the problem where the swap agreements failed? It seems only a few years ago we were restructuring Mexican debt, why are we here again? How much is enough?

I want to restore confidence in Mexico, but Mexico needs to restore confidence in Mexico. I want Mexico to flourish and succeed financially. I support Mexico's ongoing efforts to achieve a democratic, free market economy, a strong peso, and stable capital markets—however, I am not convinced that the American taxpayer needs to be the insurer here, and I am not convinced that, even were we to agree to this package, it will solve the problem.

Our long history in dealing with bailouts, whether foreign or domestic, has taught me one thing—enough is never enough.

I thank the Chairman, again, for holding today's hearing and look forward to the testimony from our many distinguished witnesses.

PREPARED STATEMENT OF SENATOR LAUCH FAIRCLOTH

Mr. Chairman, thank you for holding this hearing today. I think that this subject is very important to the United States.

Mr. Chairman, the proposed Mexico bailout is both bad financial policy and bad foreign policy.

During 1994, Mexico engaged in an age-old practice of spending billions of dollars to artificially prop up the value of its currency in order to secure election of President Salinas' hand-picked candidate. Once new President Zedillo was sworn in, however, that policy simply couldn't continue because Mexico didn't have the resources to let it continue. Now we are being asked to come to the rescue.

For a number of reasons, I think that this is a bad idea. Mexico's foreign debt—$160 billion—is considerably higher today than it was in 1982 when they suspended interest payments and precipitated the Latin American debt crisis.

Mexico has already or will receive $25 billion in assistance to aid its financial situation. Nine billion dollars of this will come from the United States. Apparently, this is not enough—even though the amount of foreign held Mexican short-term bonds is $17 billion. By this plan, the United States has committed itself to covering the full amount of *all* Mexican short-term bonds outstanding and bank lines of credit. If the full aid package were approved, this would cover 36 percent of all of Mexico's foreign debt.

We are told that Mexico is suffering from a crisis of confidence, but that its economy is fundamentally sound. Under the loan guarantee plan, Mexico will pay the United States nearly $4 billion. If Mexico's economy were generally sound, I believe that the private sector would be looking to profit from helping Mexico through this crunch. That, apparently, is not going to happen, and we need to know why.

Unfortunately, in the face of this crisis, President Clinton chose a flawed strategy that he has followed before—a massive Government intervention. Like before, the plan is meeting resistance from ordinary Americans and for good reason. The working taxpayers of this country do not understand how we can afford to send Mexico $40 billion when the United States is going into debt each and every day by $700 million.

I would note that the United States already has $51 billion in loan guarantees outstanding to foreign governments. This plan—in one act—will nearly double that commitment.

Finally, Mr. Chairman, since this bailout was announced, I have felt that it would backfire on us and create a backlash in Mexico. Over the weekend, the Mexican legislature passed a resolution that *they*—yes they, Mexico—would have to approve *our* bailout. Already protesters in Mexico are demanding a nationwide referendum on the bailout. In Mexico City, others were burning the American flag. This is the thanks we get for our generosity.

I think the Clinton Administration needs to go back to the drawing board and come up with a plan that does not make the American taxpayers a co-signer on a $40 million loan.

Mr. Chairman, let me conclude by noting my concern on another matter. I want to ask Mr. Greenspan about what the United States is doing differently from Mexico. After all, the United States has a large debt and so does Mexico. We have a huge trade deficit, and so does Mexico. The United States is spending our money on short-term needs, and so is Mexico. It seems to me that the fundamental economic problems that Mexico is facing are the same that the United States is facing. The only difference is that, if our country gets in serious trouble, no one is going to bail us out.

Thank you, Mr. Chairman. I look forward to the testimony.

PREPARED STATEMENT OF ALAN GREENSPAN

CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, WASHINGTON, DC

JANUARY 31, 1995

I am pleased to appear before this Committee today to review the Mexican economic and financial situation and the important efforts underway to avoid a major international financial disruption and to restore market confidence in Mexico.

Mexico's current financial difficulties are best understood in the context of much broader trends in international finance during the last 10 to 15 years—the globalization of finance—in which Mexico, in recent years, has participated and from which it has benefited. As a result of very rapid increases in telecommunications and computer-based technologies and products, a dramatic expansion in financial flows across borders and within countries has emerged. The pace has become truly remarkable. These positive technology-based pressures have affected the behavior of markets to a point where governments, even reluctant ones, increasingly felt compelled to deregulate and free up internal credit and financial markets.

While there can be little doubt that these extraordinary changes in global finance have on balance been beneficial in facilitating significant improvements in economic structures and living standards throughout the world, they also have some potential negative consequences. In fact, while the speed of transmission of positive economic events has been an important plus for the world in recent years, it is becoming increasingly obvious, and Mexico is the first major case, that significant mistakes in macroeconomic policy also reverberate around the world at a prodigious pace. In any event, progress—and, indeed, developments affecting the emerging global financial system are truly that—is not reversible. We must learn to live with it.

Mexico, which had been hobbled for a number of years following the debt crisis of 1982, has more recently gone through a major economic metamorphosis toward significant improvement in its economic and financial structure. As a consequence, Mexico has been able to broaden its participation in the global economic and financial environment.

Over the past decade, Mexico has made major strides. It has shed what was an inflation prone, highly unstable, economic structure with excessive government involvement and has taken on the characteristics of a vibrant economy oriented toward open markets. As a result, in 1990, Mexico was able to reenter the international credit markets on a significant scale. Foreign investors began voluntarily lending to Mexico substantial amounts for the first time since 1982. Shortly thereafter, as is characteristic of the new global financial system, foreign capital investment in Mexico began to accelerate. Indeed, in 1992 and 1993, the inflow of capital was so considerable that the Bank of Mexico had to *buy* dollars on a substantial scale to prevent the peso from becoming too strong. As a consequence, Mexico's international reserves increased to well over $25 billion at their peak in early 1994 from under $10 billion in 1990. Nonetheless, Mexico's trade deficit soared and its current account deficit reached approximately 6 percent of GDP in 1993.

As part of efforts to accelerate its move toward status as an industrial country, the government of Mexico endeavored to link the peso to the U.S. dollar. It adopted a complex, exchange-rate regime through which the Mexican peso was linked to the U.S. dollar via a moving exchange-rate band. Like many nations that have tried to "import" the anti-inflationary policies of another country by locking their exchange rates, to a greater or lesser extent, to the currency of a major trading partner, Mexico hoped to gain quick benefits through significant reductions in inflation. And, indeed, Mexico was remarkably successful for several years. The inflation rate fell

sharply from almost 160 percent in 1987 to 7 percent by 1994, but at the same time Mexico was losing international competitiveness and its current deficit widened.

However, the exchange rate policy adopted by Mexico was risky with little tolerance for policy error or capacity to absorb shocks. This fact is especially relevant in the context of a world where portfolio investments can shift rapidly into and out of a country. At a minimum, a close adherence to the monetary policy of the host nation is required. The breakdown of the Exchange Rate Mechanism of the European Monetary System in 1992 was a particularly striking case of trying to lock exchange rates together when comparable economic forces were not close to being identical among the countries.

Moreover, a considerable part of the surge of capital into Mexico in the 1990's has been in portfolio investments, which may move in quite rapidly but also can try to move out just as rapidly, as has been demonstrated in recent months.

Investors' appreciation of the momentum behind Mexico's transformation began to wane in early 1994, at least, in substantial part, as a consequence of noneconomic events—the Chiapas uprising, political assassination, and the August election. Foreign investors, at times, became somewhat hesitant. Such hesitation presented problems because Mexico needed to continue to finance the large excess of its imports over its exports which emerged initially as a consequence of the earlier spontaneous capital inflows. Moreover, Mexico not only needed to attract new portfolio and direct investments, but also to hold on to the portfolio investments it already had. Direct investment, by its very nature, of course, is largely immobile, but portfolio investments are less so. In this context, simply allowing the trade balance to adjust precipitously to the reversals of capital inflows could well destabilize Mexico's economic and trading relations.

As 1994 progressed, private foreign investment inflows slowed. In their endeavor to support the exchange rate and to finance the very large current account deficit, the Mexican authorities drew down Mexico's foreign exchange reserves. At the same time, Mexico borrowed short term in dollars and in Tesobonos, which are debt obligations the peso value of which is linked to the peso-dollar exchange rate. Mexican authorities, evidently, believed or fervently hoped that the reduction in foreign investor interest was temporary and that after the uncertainty of the August election was behind them, confidence and private capital inflows would reemerge. If so, they were tragically mistaken.

Meanwhile, it became increasingly clear to many observers during the autumn that the prevailing level of Mexico's exchange rate could not be sustained short of a significant further tightening of monetary policy. But by then, it was by no means clear that the degree of tightening required to support the peso was consistent with economic growth. Mexican authorities, apparently, were loath to risk recession, hoping instead for a spontaneous return of foreign confidence and capital. But, in retrospect, it is clear that even if private capital inflows had again accelerated, it was unrealistic to expect them to match the pace of 1993, which was arguably unsustainable. The chosen alternative to dramatically tightened monetary policy, borrowing via Tesobonos and drawing on reserves to intervene in the foreign exchange market, had a limit. Indeed, that limit was reached on December 20, and the defense of the peso came to an abrupt end.

Had the adjustment of the peso been made much earlier in the context of a much tighter monetary regime, it is likely to have resulted in a more limited decline rather than in the abrupt collapse that Mexico experienced.

I suspect that had this episode played out, say, a couple of decades ago, when the global financial system was far less sophisticated, the immediate decline in the peso's value would have been far smaller than the more than 30 percent decline experienced since December 20. The ability of foreign and, no doubt, domestic portfolio capital to flee into dollars was far less 20 years ago. Conversely, it probably would not have been possible for Mexico to have attracted so much foreign portfolio capital in the first place.

Looking back, the moving exchange-rate band for the peso apparently failed to compensate fully for the widening differential in prices of tradable goods denominated in dollars compared to such prices denominated in pesos. Accordingly, the peso exchange rate at 3.5 to the U.S. dollar was arguably not sustainable indefinitely, short of an unrealistically massive increase in domestic saving in Mexico or a continuation of the very large foreign capital inflows of 1992 and 1993 with such inflows being heavily invested in cost-reducing capital formation. It is imaginable that such a continuation of private flows could have sustained the exchange rate while bringing the underlying Mexican cost structure into line with 3.5 pesos to the dollar, but the needed level of private capital inflows that would have to have been invested in capital formation—rather than being devoted to increased consump-

tion—could not credibly be sustained. In the end, Mexico's high-risk exchange-rate strategy failed.

As a consequence of Mexico's financial difficulties, and the potential movement of vast, financial resources around the world, the problem that we now face is that there have been withdrawals of capital from a number of widely dispersed nations—industrial as well as developing. If economically advanced Mexico is having difficulties, it is being argued, perhaps the outlook for other nations dependent on foreign capital inflows is suspect more generally. Financial markets in Brazil and Argentina already have felt the repercussions of Mexico's problems. There is also some evidence that similar pressures have emerged in other developing countries, those not even remotely related to Mexico, for example, in Asia and in central Europe, as well as in a few industrial countries.

Financial officials, both here and abroad, initially thought it possible that the difficulties in Mexico would reach a climax and resolve themselves, and that market adjustments would quickly be made, removing the threat of widespread contagion affecting the international financial system. Mexican financial markets and the peso continued to fester and showed no evidence of stabilizing, and we at the Treasury and the Federal Reserve concluded that a resolution of the situation was not imminent, short of more dramatic action to confront Mexico's confidence problem.

The situation had moved beyond one capable of being addressed by short-term lending facilities provided by the Exchange Stabilization Fund of the U.S. Treasury, the swap arrangement of the Federal Reserve System, and other central banks acting through the Bank for International Settlements. The decision to implement the type of guarantees of credit market borrowings by Mexico that now appears to be necessary has broad implications that can only be addressed appropriately by the political leadership of this country.

The objective of the proposed guarantee program is to halt the erosion in Mexico's financing capabilities before it has dramatic impacts far beyond those already evident around the world. This program, in my judgment, is the least worst of the various initiatives which present themselves as possible solutions to a very unsettling international financial problem. Our concerns are not so much with potential losses to the American taxpayer, which we believe will be minimized, but with what economists call moral hazard where the active involvement of an external guarantor distorts the incentives perceived by investors. Thus, appropriate conditionality must be associated with the guarantees to underline the fact that they are being provided at high cost and on rigorous terms in exceptional circumstances. Moreover, Mexico's economic policies are the key to ensuring that the guarantee facility actually does help to stabilize the Mexican economic and financial situation; ultimately, only sound policies that are sustained over time will restore investors' confidence in Mexico. External guarantees can only offer temporary support. Nonetheless, I see no viable alternative to the type of program that is being presented to Congress if the financial erosion is to be stanched before it threatens to become a wider problem.

I want to emphasize that once the Mexican situation is stabilized, it will be important for the authorities of leading governments to examine closely the lessons to be learned from this latest episode in international finance, and to determine how to deal with similar emerging financial problems that have implications for the health of our free market-based international financial system.

I have no doubt that, as a consequence of the Mexican episode, other developing nations have become sensitized to the problems of depending too heavily on large inflows of foreign portfolio capital. This tendency of the new global financial system should, as a consequence, become largely self correcting in much the same manner that recent losses on derivative instruments have helped to condition those markets.

What happens to Mexico is of particular importance to the United States. Because of the extensive interchanges across our common border, our economic destinies are closely intertwined. Mexico is the third largest market for U.S. exports and the third largest source of U.S. imports, with about $50 billion shipped each way last year. Illegal immigration from Mexico is inversely related to economic growth and progress in Mexico. It is important to the United States, politically as well as economically, therefore, that Mexico succeed in reestablishing sustained non-inflationary growth. To achieve this, market confidence in Mexico's economic potential and financial stability must be restored.

However, what happens in Mexico also must be viewed from a larger, historical perspective. The developments of recent weeks also need to be evaluated in the context of the Cold War and its aftermath. It became particularly evident to developing countries over the past decade that the economic and political regime that characterized the Soviet Union was fatally flawed, and that the economic structure of the United States and the rest of the industrial world, based on free markets and private ownership, was clearly a superior model for developing nations to emulate. In-

deed, in recent years there has been a remarkable trend in that direction characterized by pervasive privatization, price and wage decontrol, and the development of financial structures as developing countries endeavored to replicate elements of the advanced free-market economies.

The model of economic and political transition from a rigid state-directed system toward a free-market structure was perceived to be Mexico. Starting from a low base in the mid-1980's, Mexico managed to turn itself around in such an extraordinary way that many of the finance ministers and central bankers of the developing nations looked to, and consulted with, their counterparts in Mexico to learn the mechanisms that the Mexican authorities had employed to achieve near-first-world status. Indeed, in 1994, Mexico was admitted to the OECD, the organization of industrial nations, a de facto badge of first-world status.

Unless Mexico's efforts to restore economic stability and financial market confidence succeed, years of economic reforms in Mexico would be threatened by pressures to reimpose controls in many areas of its economy and to reestablish governmental interference in Mexico's increasingly vibrant private sector. In addition, a reversal of Mexico's economic reforms and a spread of Mexico's financial difficulties to other emerging markets could halt or even reverse the global trend toward market-oriented reform and democratization. This would be a tragic setback not only for these countries, but for the United States and the rest of the world as well.

PREPARED STATEMENT OF L. WILLIAM SEIDMAN

CHAIRMAN OF THE BOARD, COMMERCIAL MORTGAGE ASSET CORPORATION; FORMER CHAIRMAN OF THE FDIC, WASHINGTON, DC

JANUARY 31, 1995

Mr. Chairman and Members of the Committee, thank you for the invitation to these important hearings. As background for my statements, if I'm not an expert on bailouts, at least I have a lot of experience in that area. I was strongly in favor of NAFTA, so I'm not here to refight that battle.

The Mexican loan guarantee proposal raises questions on which reasonable persons may differ—as illustrated by the fact that the President and the Administration, the Chairman of the Fed, and the Republican leadership in Congress are for *it*—though what "it" is, is still not clearly defined. As Voltaire put it, "It is dangerous to be right in matters in which the established authorities are wrong."

Despite the obvious danger, I come down on the side of those who find this proposed $40 billion guarantee to be a very bad idea (see my *Wall Street Journal* article attached as Exhibit I), for the following reasons:

1. *It's bad for Mexicans.* They will be required to take directions from the United States *for 10 years* by restrictions that will, in the words of Under Secretary Lawrence H. Summers, mean:

> Conditions on their budget, conditions on the expansion of credit, conditions on how much money they can print, conditions that they have to move ahead with the privatization, conditions that will ensure we'll get repaid, that they'll have healthy economic growth.

Of course, we are already seeing Congress add additional conditions. Such conditions may be justified for such a large bailout but will inevitably lead, and already have led, to resentment by Mexicans. The potential for actual or perceived mistakes by the United States directing an economy so far from home is large. Local empowerment this is NOT! This is a step likely to lead to real foreign and economic policy problems in the future.

2. The proposal is *bad for the United States* taxpayer because it substantially increases potential financial obligations. I'm not one who believes that financial guarantees are always cost free—after all, the S&L's were given similar financial guarantees at great cost to the taxpayers. The Mexican economy will go through a recession and U.S. exports will decrease no matter what is done.

3. It is a *bad idea for the operation of free private sector markets*—not only in North America, *but around the world.* Instead of letting market excesses be worked out in the private sector, it substitutes all-encompassing government credit so that for Mexicans, their real market values cannot be determined. It creates uncertainty rather than stability for investment in Mexico. We learned at the RTC that markets never correct themselves until government gets out of the way. Further, the big beneficiaries of this intervention in the market will be the Wall Street investment

managers and their clients, a group that should be allowed to suffer the losses of their mistake. (See *New York Times* piece by Rosenthal, Exhibit II).

While I believe in free markets, I don't go as far as my old friend Secretary Bill Simon who felt that "Adam Smith's invisible hand was an unwanted intrusion to the marketplace." Still, markets do work better if the government steps out—and there is little evidence here that the world will fall apart if Mexico renegotiates its loans—it did not do so in the 1980's under much more difficult default conditions. Chairman Greenspan has said he would not support a guarantee program for Mexico alone, and it is only the "spill-over effect" to second-world markets that requires this unprecedented guarantee (Exhibit III). But the spill-over of the Mexican situation already has had a beneficial effect by cooling overheated U.S. investments in foreign and Latin markets (over $60 billion of U.S. investment in 1993 and 1994). Future potential defaults may be avoided as the result of this market reaction. After all, we need investment at home and we should not subsidize foreign competition for capital. Further, do we wish, by this bailout, to inform foreign markets that they need not worry if they borrowed enough so they are "too big to fail"?

If the proposed bailout is not the answer, what should be done? The creditors and the Mexican government should be encouraged to meet and work out an accommodation. The United States and the IMF can help, as was done the last time. I refer you to Professor Dunn's article (Exhibit IV). Our objective should be to create a mechanism for dealing with such defaults, not a subsidy as a reward for mistakes. We can also provide appropriate support for a Currency Board (see Mr. David Kale's piece, Exhibit V).

Many Members of Congress have been looking for reasonable intellectual ground to turn down this "bailout" proposal which the American people and their own gut instincts tell them is unwise. (It truly is a bailout in every sense of the word.) I believe the material provided gives more than an adequate basis to return to the drawing board on this problem.

Please, especially, refer to Exhibit III, Pearlstein, "Guess Who's Running America?"; Exhibit V, Hale, "Emerging Markets After the Mexican Crisis"; Exhibit VI, Melloan, "On Mexico, the U.S. Congress Just Doesn't Get It"; and Exhibit VII, Norris, "How Foreigners Invest, and Lose Their Shirts."

There's an old proverb which says, "No matter how far you've gone down the wrong road, turn back."

MONDAY, JANUARY 23, 199[illegible]
THE WALL STREET JOURNA[illegible]

EXHIBIT I

Block the Bailout: Let Market Solve Mexico's Woes

By L. WILLIAM SEIDMAN

Congress is right to hesitate in bailing ut Mexico. The Mexican government ap-arently will not be able to meet its debt obligations when due, and the current ad-ministration wants the U.S. government (i.e., the U.S. taxpayer) to ride to the res-ue with some kind of $40 billion loan guar-antee—shades of the bank and S&L crises of the 1980s and the banks considered "too big to fail."

Wall Street investors, the leadership of both parties and foreign governments cheer the proposed rescue. Huge market losses by mutual fund investors and others in the foreign securities market would be eased by good old Uncle Sam. No wonder financial markets cheer: The hangman's noose would be removed from their necks—and what's more, proponents say, billions of dollars of losses would be elimi-nated without any cost to the savior, the U.S. taxpayer. Wow! Too good to be true? You guessed it!

Mexico in the first years of the Salinas term did a fantastic job of restoring its economy by doing all the right things: re-ducing government spending, balancing the budget and privatizing industries. World markets responded and Mexico be-came a member in good financial stand-ing, able to borrow in the credit markets (particularly in the U.S. market).

Like a kid in the candy store who sud-denly has unlimited access to the open counter and grabs more than is good for him, the Mexicans took advantage of their new credit-worthiness and took on more debt than they could handle. The result was a debt stomachache from over-con-sumption. When the illness began to show, the markets reacted by dumping Mexican debt and pesos. Mexico responded by try-ing to prop up the peso and used over half of its dollar reserves before giving up the doomed effort.

A market judgment "mistake" had been made by investors and lenders who didn't properly evaluate the situation: The Mexicans were overdoing a good thing and had borrowed too much. This is the crux of the current problem. Why should anyone be bailed out by the U.S. government, and perhaps others, for a business mistake? Market mistakes happen daily.

* * *

Proponents of a bailout say that a fail-ure to mount one will cause a world-wide financial crisis, that Mexico is too big to be allowed to fail—i.e., default. But Mexico was in default on its old debt for most of the 1980s, and the world economy sur-vived. The debtors and creditors worked things out, without massive government guarantees, and losses fell to those who had made the market misjudgment. Fur-ther, the Mexican economy will be back to reality and the reduced value of the peso should result in increased exports, as it did in Chile after it went through a far worse devaluation in 1982.

Bailout proponents retort that the fail-ure this time is too big to allow because we have a market panic on our hands that is affecting all the Latin American markets and even those of some Third World coun-tries—all markets that had been in style for investment and were booming. They say that the panic must be contained be-cause there is no real problem with the Mexican economy, which is sound in the long-term. Thus, the U.S. must stop the panic

Of course, panic is enhanced by talk of panic. But those who are true believers in markets also ought to believe that if there is no real economic problem, the panic will ultimately subside. As we learned at the Resolution Trust Corp., the market never corrects itself until the government steps out of the way. Thus, at the RTC we sold off real estate despite protests that the government had to withhold sales and stabilize the market.

* * *

Unfortunately, there is a real Mexican problem—too much short-term borrowing. Borrowing short-term and investing in long-term assets or, worse, in consumer goods, usually leads to this kind of problem. This economic error can be corrected only by recognizing losses—unless, of course, there is a bailout by the government. (It is interesting to note that as the result of the tendency of U.S. politicians and us bureaucrats to use bailouts for big banks, legislation was passed making it extremely hard to use them. Moreover, even the U.S. bailouts of big banks were aimed at depositors, not investors.)

What of the argument that no matter what the cause, the U.S. can alleviate all this pain and loss with a "no cost" loan guarantee solution? Insuring a debtor who has a real problem is not likely to be cost free. The insurance premium for a policy on someone who has just had even a mild heart attack is always high because the risk of loss is high. Co-signing a note for $40 billion now is practically a guarantee of the Mexican government, no matter what the government of Mexico does in the future, and no matter what group is in charge. We don't have the details, so it can only be said that to the extent that we seek to protect our guarantee, the U.S. will have to try to constrain the Mexican government, a policy sure to create resentment against the colossus of the north. Hell hath no fury like that of the debtor told how to run his life by a rich and overbearing creditor.

The right answer to the problem at hand is to let the debtor and creditor settle matters in the good old American way: between themselves. If Mexico needs foreign aid (and it may), let the aid be provided by congressional appropriation after careful evaluation of what is required.

Congress is right to hesitate. Although reversing course at this point will be difficult and the screams of disaster will be deafening, the course being set in haste can only lead to larger U.S. financial obligations and a reduction of market discipline. That's just the way we don't want to go.

Mr. Seidman was chairman of the FDIC from 1985 to 1991 and of the RTC from 1989 to 1991.

EXHIBIT II

NY Times 1/24/95 A27

On My Mind

A. M. ROSENTHAL

$40 Billion Questions

It's a normal thing: ask for a loan, or go co-signer, and you have to answer a few questions.

We don't want to seem stingy or mean, but maybe U.S. and Mexican officials involved in the Mexican economic disaster would not mind skipping their press conferences and do a little answering under oath. After all — $40 billion, you know.

1. Exactly when did these officials find out Mexico was in deep trouble because of its borrowing from foreign and Mexican investors?

Two New York Times correspondents (David E. Sanger and Anthony DePalma) report that in the summer of 1994, both governments knew about it. Which officials, please?

2. Seeing trouble coming, what did they publicly tell Mexicans and Americans so they could hold up before buying more pesos or bonds?

Nothing, it appears, even though some investors were getting private word that made them antsy.

3. Why the silence?

The Mexicans did not want to interfere with the grand economic press they were getting, or with the ambitions of two politicians. Ernesto Zedillo wanted to be elected president. The outgoing President, Carlos Salinas, wanted to be chosen head of the World Trade Organization. Any audible gurgles from a Mexican economy drowning in debt would not do either man much good.

4. And the U.S.: Could it be that the Administration had so enthusiastically promoted Mexico that it would have been terribly embarrassing — an election coming up and all — to disclose that Mexico "suddenly" could not go on backing up its pesos and bonds unless the U.S. offered heavy loans to bail out investors?

These questions and others raised by the conduct of the two Governments point to deliberate concealment of important reality — cover-up, you might say.

So: It is not common sense to lend $40 billion more to a country whose leaders so botched things up, to be handled by the same American officials who participated in tamping down the economic truth.

The Administration and some investors tell us not to worry — the collateral will be Mexico's oil revenues. Also we will watch their economy, like regular hawks.

Great: First we become the day-to-day overseers of the Mexican economy. The Mexican people will just love that. Then, if Mexico defaults, Sheriff Yanqui goes in and grabs the oil revenues that it regards as a national patrimony.

The only way the Mexican Government could prevent a revolution would be to renege on oil payments before the first one was made.

Americans who talk about seizing Mexican oil revenue seem never to

understand the deep national emotions of third-world citizens — particularly when told to shut up because they can't afford pride.

Given those passions, the political explosiveness of the collateral and the cover-up record, the loan carries risk and is not the failproof "loan guarantee" both countries say it is.

Then the question is if the $40 billion is needed to save Mexico and the world economy. Who says so?

Representative Charles Schumer, the New York Democrat, is proposing something less grandiose. He says lend Mexico less than $10 billion, for one year. Then use our clout in the World Bank and International Monetary Fund to get them to take over. That would reduce U.S. risk, but not thrill the other nations. (If the collateral is sound and the cause so important, why do Germany and Japan, eager trading partners of Mexico, so demurely hang back from making the loan?)

Economic aid is often justified — but not $40 billion to a country whose mess was created by the cowardice of bureaucrats and the mistakes of investors, theirs and ours.

The Mexican-U.S. botch-up.

Americans would be foolish — I am being exquisitely polite today — if they agreed to any loan before they found out which American and Mexican investors would be the big beneficiaries. Then, we need aloof testimony from expert non-officials and non-politicians on how much damage would really be done if the loan is refused.

Would it touch off world crisis — or just prevent losses that countries and investors should handle themselves — if they want to play big shots in a free market?

And those questions at the beginning — even for a miserable $10 billion, sworn testimony would be nice. ☐

EXHIBIT III W.P. 1/29/95

Guess Who's Running America?

Above All, Alan Greenspan—His Invisible Hand Touches Us All

By Steven Pearlstein

AT A TIME when Americans have embraced a smaller role for government and economic planning is in disrepute around the globe, one group of Washington policy makers—the Federal Reserve Board—is having a hard time keeping its hands off the economy.

On Tuesday, Federal Reserve Chairman Alan Greenspan and his colleagues will decide whether to raise interest rates for the seventh time in a year in an effort to slow down an economy that most business executives and consumers think is doing just fine. At the same time, Greenspan is hip-deep in the government's effort to rescue the Mexican economy, helping to shape the terms of a proposed $40 billion loan guarantee package and sell it to a reluctant Congress.

As a Ronald Reagan appointee and a disciple of Ayn Rand's unyielding free market theology, Greenspan is an unlikely candidate for the role of econometer—fixing prices, bailing out key industries, intervening in financial markets and actively managing the ups and downs of the business cycle.

In an ideal world, Greensp ͺ has said, he would do away with even the most wic ͺ accepted government interventions in the economy, uch as Social Security, welfare and antitrust laws. Ev ͺ after government loan guarantees saved Chrysler Corp. from bankruptcy, Greenspan told Time magazine that such deals only delay "the shift of resources into more productive ventures."

But at a time when financial arrangements around the world are in a state of flux and political leadership is relatively weak, it has fallen to central bankers to keep economies on an even keel. And Greenspan seems to have taken up the challenge enthusiastically, serving as a backdoor adviser to the White House, muscling administration officials on regulatory issues, briefing congressmen and reporters and opening the first, tentative lines of communication between the public and the normally secretive Fed.

"These days he's certainly doing a very good imper-sonation of somebody trying to run an economy," says Jim Grant, publisher of a widely read newsletter on interest rates.

In the case of Mexico, for example, Greenspan says he is obliged to support intervention to prevent one default from leading to another and another, destabilizing the world's highly interdependent financial markets and prompting a worldwide depression. Just such credit panics led to the chartering of the Fed back in 1913.

That rescue effort, however, would also spare the Mexican government the full punishment for its misguided economic policies that the free market would have meted out. And U.S. banks and mutual funds would also be held harmless for their bad judgment in lending Mexico tens of billions of dollars when prudence would have dictated otherwise. Furthermore, by extending the explicit guarantee of the U.S. Treasury to bonds that Mexico might issue in the future, the rescue effort represents exactly the sort of government-induced "shift of resources" that Greenspan bemoaned in the Chrysler case.

Mindful of these dilemmas, Greenspan's line has been that the bailout is a distasteful but necessary step to get a fundamentally sound Mexican economy back on its feet—the "least worst of the various solutions," he told Congress last week. But William Seidman, who learned all about bailouts as head of the government's savings and loan rescue, suspects that fears of a world financial collapse are overblown.

"Those who are true believers in markets also ought to believe that if there is no real economic problem [in Mexico], the panic will ultimately subside," Seidman wrote last week in the Wall Street Journal. "As we learned in the [S&L bailout], the market never corrects itself until the government steps out of the way."

Even before the Mexico crisis, Greenspan and his Fed colleagues took a similarly interventionist stance here at home when they embarked on a stimulative monetary policy in early 1992, holding short-term rates below where they might otherwise have been. One reason for that policy, Greenspan said in a speech this year, was to give financially strapped U.S. banks a chance to repair the damage done to their balance sheets by ill-advised real estate loans in the 1980s.

But this bank-saving medicine was not without its unpleasant side effects. During this same period, small- and medium-sized businesses complained that they couldn't get loans, in part because banks could earn such a good profit, at virtually no risk, by borrowing short-term money at the Fed's low short-term rate and investing it in higher-yield long-term Treasury bonds. The credit crunch was cited by many analysts as a factor in the slow pace of economic recovery in 1992 and the first half of 1993.

In February 1994, the Fed raised rates to what it called a more "neutral" posture. But as the economy finally began to pick up momentum in late spring, Greenspan and his colleagues decided that neutrality was untenable. In a series of rate hikes, they embarked upon their current policy of restricting economic growth.

In defending the higher rates, Greenspan and other Fed officials have pointed to a growing number of bottlenecks in the economy—shortages for key materials or workers with certain skills—that have triggered price increases. Their fear is that these increases will soon trigger others, creating an inflationary psychology and an upward spiral of wages and prices. Yet the Fed has launched its "preemptive strike" even before any acceleration of inflation has shown up in

the overall numbers—and, by its own admission, earlier in the business cycle than previous Fed boards acted.

Because it is vested with such wide-ranging powers to set short-term rates and determine how much money is in circulation, it is probably impossible for the Fed to take a purely passive role in the economy. But a number of business executives and analysts question whether the Fed can—or should—try to manage the economy with such precision, insisting, as it seems to, that economic growth drop below 3 percent and unemployment remain comfortably above 5 percent.

Not surprisingly, Nobel-winning economist Milton Friedman, who once proposed replacing the Fed with a computer, disapproves of the impulse. "The desire to fine-tune the economy is almost irrepressible. If we knew enough, it could be useful, but because we don't, it is almost misguided," Friedman said last week from his office at Stanford University's Hoover Institute.

Friedman, like the early Greenspan, is a free-markets man. But even economists who have never shared Greenspan's ideological objections to government interventions have misgivings. "There is a great hubris in the belief that by changing the cost of financing, the Fed can control the pace of economic activity," says Hyman Minsky, an economist at the Jerome Levy Institute in New York. "It is a level of fine-tuning greater that even we liberals used to think possible."

Adds newsletter publisher Grant, "This process of setting out precise targets for the economy is the sort of thing socialist government used to do."

One reason socialist governments no longer exist, in fact, is that economics has proved to be much less exact a science than physics, and therefore policy based on economic thinking can turn out to be widely off the mark.

Just last week, for example, Northwestern University economist Robert Gordon, whose work is closely followed by the Fed, backed off from his long-maintained assertion that an unemployment rate below 6 percent was inflationary for the economy. Gordon now thinks the economy has become flexible and supple enough to handle unemployment rates of 5.5 percent or even less—a stunning recantation that calls into question the timing and aggressiveness of the Fed's intervention.

Friedman, who first sketched out the idea that there is some "natural" rate of unemployment below which it is unhealthy to go, now regrets that his theory is being used to justify the Fed's tinkering. "The natural rate was part of an argument against trying to fine-tune the economy, not in favor of it . . . ."

Like Friedman, Washington economist Joel Popkin argues that Greenspan and his Fed colleagues may be underestimating the ingenuity of the economy in correcting it own imbalances. For example, as steel prices have climbed 15 to 25 percent over the last two years, the steel industry has announced plant additions that will increase capacity by 13 percent. As that capacity comes on line, steel supply will increase and prices stabilize—all without government involvement.

But, says Popkin, if investors see the Fed trying to brake the economy at the first sign of bottlenecks, this natural process of self-correction may never take place.

Robert Eisner, the Northwestern University economist and author of a recent book, "The Misunderstood Economy," compares the economy to a patient suffering from clogged arteries. "The patient would have a longer and better life by exercising and expanding the capacity of his heart and circulation system," says Eisner. "But what Dr. Greenspan has done, I think unwisely, is to simply put the economy to bed."

No matter what the Fed does this week, controversy will continue for the next several months over how much of the Fed's bed rest the economy really needs. But Friedman, at least, has no doubt that the Fed will persist in its active ministrations. "The problem with working in Washington," he says, "is that the practice of exercising power is corrupting—the more you do it, the more you want to do it. And soon enough, you begin to think you're in charge."

Other central bankers, apparently, have succumbed to the same temptations. In a new book, "The Central Bankers," British journalists Marjorie Deane and Robert Pringle argue that monetary policy became "the only game in town" in the mid-1970s when it became clear that the elected branches of government were failing miserably in managing their economies. Instead of using the government's spending and taxing powers to

try to dictate an explicit rate of economic growth—the old Keynesian formula—the new approach tries to manage growth indirectly by manipulating interest rates and controlling inflation—the traditional province of the central bankers.

Perhaps no central banker was more successful, or at times more ruthless, in pursuing the new approach than Paul Volcker, Greenspan's predecessor at the Fed. But in an introduction to "The Central Bankers," Volcker warns his former colleagues not to let their newly found power and influence go to their heads. Central bankers, he writes, should remind "themselves of what they are wont to warn others about: excess of zeal and confidence."

Steven Pearlstein writes on economics for The Washington Post.

EXHIBIT IV W. Post

Robert M. Dunn Jr.

$40 Billion for Wall Street

Carla Hills argued on this page Monday that Congress should approve a $40 billion Mexican loan guarantee program because our neighbor to the south faces a "three alarm economic blaze" that will cause untold catastrophe if the United States does not put it out. The facts of the matter are that Mexico faces a debt problem which is similar to that faced by Latin American countries many times in the past, and that the people who are most threatened by the difficulty, and who would therefore benefit from the proposed arrangement, are primarily in New York (and to a lesser extent Tokyo and elsewhere) rather than Mexico.

The proposed $40 billion bail-out is really a rescue package for investment bankers and mutual fund managers in New York and other financial centers, who took huge risks in exchange for very high interest rates in Mexico during the early 1990s, and who now want the rest of us to pay for their mistakes. If U.S. taxpayers are to subsidize unfortunate investors in Mexico, why not losers in the stock market, or Orange County or people who bought houses that went down in value?

To understand why it makes no sense for U.S. taxpayers to guarantee $40 billion in Mexican debt, it may be useful to understand how this mess developed. Back in 1992-1993, when short-term yields in the United States fell to 3 percent, which was about zero in real terms, U.S. investors became extremely eager to find assets that paid more.

Throughout history such searches for high yields have resulted in investors taking excessive risk, and history repeated itself. Many managers of hedge funds used borrowed money to buy 30-year bonds with higher yields, meaning that if interest rates went up, they would take large losses on the bonds. Other investment managers were attracted by Mexican short-term debt that paid 12 percent or more. Since these

Taking Exception

Wall Street operations were not amateurs, they had to understand that Mexican debt paid such high yields because of sizable exchange rate and default risk. The investment managers accepted these risks, on behalf of their clients, in exchange for the high yields.

As nervousness about the exchange rate increased, Mexico switched these loans to a dollar guaranteed form at somewhat lower yields. About $30 billion was borrowed at short maturities with principal and interest payable in pesos, but with such payment to be adjusted for any exchange rate change. This meant that the debt was really denominated in dollars.

Mexico needed these funds to finance an annual current account deficit that exceeded $25 billion, or about 8 percent of GNP. Such huge deficits would have appeared unsustainable to most observ-

ers, but as long as U.S. interest rates remained low, relatively high Mexican yields, combined with euphoria over NAFTA, attracted the necessary money.

The party ended when the Federal Reserve System tightened U.S. monetary policy last year. As U.S. short-term yields rose by three percentage points and long-term Treasury yields approached 8 percent, a lot of risky assets, including Mexican debt, became less attractive. Just as money goes into high-risk assets in periods of low interest rates, a tightening of monetary policy always produces a "flight to quality." While the Dow-Jones industrial average, which represents large firms, remained almost unchanged over 1994, stocks of smaller companies declined sharply. Junk bonds became garbage bonds, and risky borrowers, like Mexico, started to have great difficulty in rolling over their debts.

As Mexico's foreign exchange reserves fell to a small fraction of the country's outstanding short-term debt, investors started to flee, and a depreciation of the peso became necessary. Now the New York investment managers want to be paid. Mexico does not have the money, so they will have to wait. But no, the U.S. taxpayer will come to the rescue with $40 billion in loan guarantees. We now have a wonderful recipe for prosperity on Wall Street: When risky assets pay, keep the money and complain about high taxes. When such high-risk assets approach default, get the U.S. Treasury to cover the losses.

There is no reason for U.S. taxpayers to provide $40 billion for Wall Street. Mexico needs to wait for the depreciation of the peso to improve its trade balance and prevail upon its creditors to be patient. The three-month debt should have a zero added to become a 30-month debt, while Mexico tightens domestic fiscal and monetary policies to augment the effects of the lower exchange rate for the peso on its current account. If more help is needed, it should come from the International Monetary Fund with standard conditionality terms.

The Wall Street investment bankers and mutual fund managers will not be happy, but they accepted the risks in exchange for high Mexican yields, so they deserve little sympathy. Mexico borrowed too much money to finance an excessive current account deficit and should not be protected from the costs of that decision.

Republicans in Congress tell us that everybody needs to be responsible for his actions and that welfare is going to be reformed to make that clear to the poor. If we are going to have a Personal Responsibility Act for welfare mothers, maybe it should be applied to Wall Street and to Mexico City.

The writer is a professor of economics at George Washington University.

Kemper Financial

EXHIBIT V

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Emerging Markets After the Mexican Crisis

January 17, 1995 by David Hale, Chief Economist

The recent collapse of the Mexican peso and its negative spillover effects on other Latin American stock markets has demonstrated the fragilities of the post cold war boom in securitized capital flows to developing country financial markets. If governments do not respond to the crisis correctly, it could retard capital flows to all emerging markets during the mid-1990's and greatly retard the growth prospects of some countries still in transition to market oriented economic systems.

The first vulnerability which the Mexican crisis exposed is the low savings rate of the western hemisphere. Except for Chile, every nation in the western hemisphere is an external debtor and has a savings rate well below the levels prevailing in east Asia as well as many European countries. Mexico was able to boosts its rate of investment in the face of a low domestic savings rate by importing large amounts of capital vis a vis its stock and bond markets. American investors were large buyers of Mexican financial assets during the early 1990's because the low level of interest rates prevailing in the U.S. and a growing awareness of the benefits of global portfolio diversification encouraged an unprecedented demand for foreign securities. In 1993, for example, U.S. capital outflows to purchase foreign securities reached a level equal to 1.7% of GDP or a level in excess of Marshall Plan transfers to Europe during the late 1940's. The U.S. was able to export capital on a large scale despite its low private savings and large full employment budget deficit because foreign investor were enthusiastic purchasers of U.S. securities during the bull market of 1992-1993 and the Japanese government was willing to spend $60 billion supporting the U.S. dollar when private capital inflows slowed down. This transnational money chain made Mexico's capital account highly vulnerable to changes in American interest rates and foreign investor perceptions of the U.S. dollar, not just market concerns about Mexico's burgeoning current account deficit. Mexicans began to sell the peso aggressively in December because they feared that in an environment of rising U.S. interest rates, there would not be sufficient surplus liquidity in the savings deficient U.S. economy to finance a Mexican current account deficit of 8-9% of GDP at an exchange rate which was higher in real terms than the peso on the eve of the 1982 debt crisis.

The second vulnerability which the peso crisis has exposed is the greatly increased sensitivity of securitized capital flows to adverse news events compared to commercial bank lending and foreign direct investment, the primary sources of private capital for developing countries before the 1990's. Managers of mutual funds and pension funds have very different attitudes towards currency devaluations than commercial banks or multinational companies. Commercial banks with dollar loans do not object to currency depreciation in developing countries with large trade deficits because they can improve the credit rating of the country by boosting exports at the expense of domestic consumption. Multi-national corporations also can benefit from a currency devaluation if they are using the country as an export base. The portfolio managers of mutual funds and pension funds operate under very different constraints. Although they understand that currency devaluations are sometimes a necessary component of an economic restructuring program, they do not like unpredictable exchange rate policies in cases where they are large holders of debt and where the equity market is dominated by companies oriented towards domestic consumption. The Mexican devaluation was traumatic because of the heavy concentration of U.S. investment in peso denominated securities without any available currency hedges, the refusal of practically all Mexican policy makers to admit to American fund managers that devaluation might even be a policy option, and the lack of any export sectors in the Mexican stock market significant enough to compensate for the large losses which would occur in the banking and domestic consumption sectors as the peso declined. As a result of the confidence engendered by NAFTA and the outstanding communications skills of key economic ministers, Mexico under President Salinas had achieved a degree of intimacy with the American financial community unprecedented for a non-English speaking developing country. During the early 1990's, it had been able to finance its expanding current account deficit nearly two thirds through sales of securities to U.S. investors whereas in most developing countries portfolio investment still accounts for only 20-30% of capital inflows. The trauma of the peso devaluation also was magnified by the moral hazard problems resulting from Wall Street's big investment in emerging market research and investment banking departments. Many firms had downplayed Mexico's exchange rate vulnerability because they were afraid that it might jeopardize the deal flow required to cover their expensive overhead at a time when Wall Street's domestic business was in recession.

As the growth of securitized capital flows to developing countries is a recent phenomena, there has been no other developing country financial crisis comparable to Mexico's in the modern era, but there were many in the half century before the First World War, when securities markets were also major channels for capital transfers between rich and poor countries. In fact, most of the great upheavals in both the U.S. and Latin American stock markets during that period resulted either from

financial shocks in Europe which reduced demand for all foreign securities or political events here which undermined foreign investor confidence in western hemisphere currencies. The best analogy to the recent Mexican crisis is the U.S. dollar crisis of 1893. Grover Cleveland had just become president and investors began to sell the dollar because of concern about his commitment to maintaining its link to the gold standard. As money left New York, U.S. interest rates rose sharply and Cleveland had to negotiate an emergency gold loan from an Anglo-American banking syndicate in order to maintain the dollar's gold parity. But once the markets regained confidence in his commitment to a stable dollar, interest rates fell and the crisis eased. Economists will long debate whether the new Zedillo administration could have avoided the recent peso devaluation by hiking interest rates as the country's foreign exchange reserves dwindled but there is little doubt that his team greatly under-estimated the impact of trying to fine tune a modest currency depreciation on investor confidence in an era of securitized capital flows. The advocates of devaluation simply did not understand the differences between importing capital from U.S. banks during the 1970's and importing capital from a mutual fund sector which has to publish daily asset prices and can suffer large redemptions if there are adverse news reports about its performance. This distinction has become critically important because U.S. mutual funds now have assets equal to almost 90% of U.S. bank deposits whereas in 1980 they were barely 10% and invested primarily in money market funds. In fact, when the history books are written, the 1995 peso crisis will be regarded as the first great liquidity crisis to result in part from the rise of mutual funds as important global financial intermediaries.

The third vulnerability which the Mexican crisis has exposed is the inadequacy of the monetary systems of many developing countries to sustain investor confidence in their commitment to low inflation and exchange rate stability during periods of political transition. According to many Mexican officials, the central bank was opposed to the devaluation but it was over-ruled by the new finance minister who did not want to slow the recovery of the economy. While Mexico's central bank was supposed to have become independent of the government over one year ago, its inability to control the exchange rate left it without an effective policy anchor. In the last great age of securitized capital flows, by contrast, most developing countries had tried to enhance their credit rating and access to foreign investment by linking their exchange rate to the gold standard. They experienced periodic crises when global recession and falling commodity prices significantly curtailed their export income, but, on the whole, the gold standard helped to facilitate a tremendous expansion of global private investment through securities markets. The magnitude of the Mexican crisis suggests that developing countries will have to re-examine their assumptions about monetary policy if they want to encourage the recent boomlet in capital flows via security markets to

continue. They will not be able to recreate a global monetary system comparable to the pre-1914 gold standard but they can pursue a number of unilateral policies to enhance their monetary credibility with both foreign investors and their own citizens.

Some countries should establish such strong independent central banks that the finance minister cannot over-rule them on exchange rate policy while others should consider converting their central banks into currency boards similar to those which now exist in Hong Kong or Argentina. Under a currency board, all monetary growth has to be underpinned by an expansion of foreign exchange reserve assets to make the currency fully convertible. Currency boards were very common in the colonies of the British Empire before World War Two and then discarded when they became independent. But there is a revival of interest occurring in them today because they offer countries with weak central banking traditions or histories of high inflation an opportunity to establish credible monetary policies more quickly than would be possible with ordinary central banks. Hong Kong established its currency board during a financial crisis in 1983 and it has withstood a decade of great volatility in both Chinese politics and U.S. interest rates. Argentina turned its central bank into a de facto currency board in 1991 in order to establish monetary credibility coincident with the introduction of a far-reaching economic liberalization program. Estonia also established a currency board three years ago to accelerate its transition into a low inflation economy as it left the ruble currency zone.

The idea of a country as large as Mexico introducing a currency board would have been unthinkable three months ago, but as a result of the severity of the recent crisis, it now deserves serious consideration. The Mexican devaluation has produced a regional financial crisis that has wiped out $150-200 billion of Latin American stock market capitalization. Interest rates in Mexico have sky-rocketed to such high levels that there will probably be a wave of corporate bankruptcies so large that Mexican banks are now having a difficult time rolling over their own liabilities. The introduction of a currency board would not be able to eliminate financial risk premiums overnight, but, if supported by an adequate international financial aid package, it would be a bold policy gesture for signalling Mexico's commitment to correcting the breech of promise which many fund managers believed took place on December 20th. There are also good geo-economic and geo-political arguments for a Mexican currency board linked to the dollar. As a result of NAFTA, the U.S. and Mexico are becoming so integrated that Mexican monetary policy should be designed to encourage more convergence with the U.S. inflation rate. A rigid fixed

exchange rate policy could create employment problems if Mexico does not correct microeconomic rigidities in its labor market but as with Argentina the currency board could be used as a spur to encourage reforms which should occur anyway.

The U.S. government has not yet attached any explicit conditions to its recent loan guarantee program for Mexico but the issue of monetary policy independence should rank high on the list of topics for future discussion between policy makers. The risk is that the U.S. loan, coupled with the $40 billion income transfer which Mexico has earned from American investors through the devaluation, will encourage some Mexican officials to advocate a prolonged period of significant peso undervaluation and high inflation as a spur to employment growth. Before December, the peso was about 25% higher n real terms than its average value since 1960 and 50% higher than its real value after the debt crisis of the early 1980's. If the peso stabilizes at 5.5, it's real value will be only modestly higher than it was at the depth of the 1980's debt crisis but such a large devaluation could encourage a return to high inflation if monetary and fiscal policy are not focused on suppressing it. As the new finance minister, Mr. Ortiz, advocated devaluation on several occasions during 1994, it is far from clear whether he will be willing to pursue a firm anti-inflation policy if the tradeoff is a prolonged period of slow growth.

The financial shocks resulting from Mexican peso devaluation have been so great that it will be impossible for Mexico to avoid a severe recession in domestic spending this year as well as a sharp increase in the level of corporate bankruptcies and credit problems in the banking system. Before the crisis, many Mexican banks had non-performing loan ratios of 8-10% and the recent upsurge in the level of interest rates will probably cause the ratio of non-performing loans to triple. As the U.S. ships about $30 billion of exports to Mexico for local consumption and another $20 billion for reassembly in the Maquiladoras zone, it will probably suffer a trade loss of at least $4-5 billion and experience a surge of imports from Mexico even larger. The ripple effects of the Mexican crisis on other developing countries in Latin America and Asia with large current account deficits may also force them to curtail their 1995 growth rates and demand for U.S. exports. The consolation for the industrial countries is that the Mexican crisis will probably reduce the current account deficit of Latin America and Asia by $30-40 billion this year and thus lessen market concerns about competition for capital with the developing countries pushing up bond yields.

What remains to be seen is whether Mexico and other developing countries can derive any long-term benefits from the recent peso crisis by re-examining three core components of their economic strategies. Can they reduce their need for high levels

of foreign capital by boosting their own savings rate? Can they introduce more liberal investment policies to boost the direct investment component of the foreign capital which they do import? Can they establish more effective monetary anchors for reviving investor confidence by introducing strong independent banks or converting their central banks into de facto currency boards?

Most developing countries have already committed themselves to promoting higher levels of domestic savings and more foreign direct investment. But there is much less of a consensus about the question of how to achieve monetary credibility. If the Argentine monetary system survives the current crisis of confidence without imposing excessive deflation on the economy, it could encourage far more extensive use of currency boards in countries trying to promote foreign investment through stock markets (Latin America) or attempting to reduce capital flight by their own citizens (Russia). But if the currency board model fails in Argentina, the risk is high that many Latin American nations will return to inflation rates as high as 10-20% on a sustained basis. Such inflation rates will not make it impossible for Latin American stock markets to attract some foreign investment but it will greatly narrow the range of investors willing to commit large sums to Latin American financial assets compared to the extraordinary boom in securitized capital flows which occurred during the first half of the 1990's.

David Hale
Chief Economist

EXHIBIT VI

THE WALL STREET JOURNAL MONDAY, JANUARY 23, 1995

On Mexico. the U.S. Congress Just Doesn't Get It

America's protectionists are trying to turn the congressional debate on a $40 billion bailout for Mexico into a replay of last year's Nafta scrum. Ross Perot and Pat Buchanan are yelling, "I told you so," and House Minority Leader Dick Gephardt is rallying Democrats against a Democratic president.

Politicians have never been very good at math, so it is not surprising that this replay of the "great sucking sound" debate totally misses the point. The bailout question has little if anything to do with Nafta, immigration or any of the other red herrings that have been thrown into the pot. It

Global View

By George Melloan

has to do with a financial crisis, one that goes well beyond Mexico's borders and has sources far more significant to the health of the world economy than Mexico's maladministration of monetary policy.

Specifically, the core of the problem lies in the overuse of debt financing, by governments, by banks and by non-bank financial institutions. Securities markets were so easily stampeded by devaluation of the Mexican peso—which is hardly one of the world's most important currencies—because the world economy is over-leveraged.

This can be the only reasonable explanation of why bond prices slumped last year, wiping out some $1 trillion in market values in the U.S. alone, at a time when there were only cursory signs of a new outbreak of inflation. Securities markets around the globe have suffered varying degrees of damage, but it is not surprising that markets in the so-called "emerging" economies have taken the biggest hits, particularly since the Mexican crisis. The real "sucking sound" has nothing to do with jobs leaving the U.S.—indeed the U.S. employment statistics offer no backing for that claim. Rather, the noise comes from American fund managers pulling their money out of emerging markets, including some where government fiscal and monetary policies seem reasonably sound.

Over the last two weeks, high-level officials from a number of countries have rushed to Wall Street to try to reassure securities houses on the safety of their investments. It's no wonder. Stock markets in such places as Brazil and Argentina quickly followed Mexican stocks in the nosedive that followed the Mexican devaluation. The standard line from these government officials has been, "Why us? We're not Mexico."

Why us, indeed? The answer is that these countries are not necessarily the problem themselves, but are the first to feel the effects of the problem. The world of finance has changed drastically over the last decade, and perhaps not for the better. Demand for capital around the globe has expanded rapidly as some big new demanders, such as China and India, have entered the market. There is nothing wrong with this per se; the world can only benefit if this capital is wisely used for genuine economic expansion.

But there also is still heavy demand for capital for non-productive purposes, such as supporting Europe's overextended welfare states and the huge U.S. federal budget deficit. The world of finance has been meeting these demands through various forms of improvisation, much of which has been made necessary by the fiscal and monetary policies of governments.

U.S. banking has changed dramatically, for example. The U.S. policy of low short-term interest rates in the early 1990s may have performed the necessary function of enabling banks to bolster their weak balance sheets through low-cost borrowing from the Federal Reserve. But it

also drew deposits out of banks into mutual funds, putting small savers into riskier forms of investment—such as emerging market funds—and forcing banks to find ways other than lending to make money. The end result has been that the U.S. pool of savings, consisting heavily of mutual funds, pension funds and the like, has shifted dramatically from the traditional fixed-return investments, such as savings accounts, to higher risk markets where it is subject to price declines.

Major banks have increasingly moved from being intermediaries between borrowers and lenders to activities, such as currency trading or arbitrage, that border on speculation. The investment flight from Mexico and the Orange County debacle are not as unrelated as some might think. In both cases, the decline in the bond markets exposed weaknesses that had not been apparent before.

The core of the problem lies in the overuse of debt financing, by governments, by banks and by non-bank financial institutions.

Market-letter specialist James Grant was quite correct on CNN a few days ago when he said that the real issue before Congress and the Clinton administration was not a bail-out of Mexico but a bail-out of American banks. But he might have broadened the field a great deal to include not only banks but the American investment community generally.

The fundamental question is whether a bailout will strengthen or further weaken the global financial system. The argument for the bailout is that U.S. guarantees of Mexican government securities will reassure investment fund managers around the globe and allow them to heed the Mexican warning in a more orderly way, with less damage to other economies and for that matter to weak financial institutions. The argument here is that those money managers who have put themselves out on the ends of some slender limbs will start crawling back toward a safer perch.

The opposing argument is a hard-line one. Let those fund managers who have been testing the higher risk levels take their medicine now. It will serve as a useful lesson that there is not always a safety net available. Moreover, if they are coddled now, they will only build up bigger risks that could be far more serious for the world economy in some future day of reckoning.

In an indirect sense, support for this argument came last week when a new offering of Mexican "Tesobonos," or dollar-backed peso debt, was oversubscribed to the tune of some half a billion dollars. These 91-day treasury bills carried an interest rate of nearly 20% but it was assumed as well that investors were betting on the U.S. bailout. Perhaps they should have been asking themselves if Mexico can really afford to refinance at such colossal interest rates the huge amount of dollar denominated debt that will come due this year. Perhaps the Clinton administration, which stresses that the $40 billion bailout is just a guarantee not a loan, should be asking itself whether it is being entirely frank with Congress and the American people.

Indeed, large blank checks of this sort that the U.S. government has been issuing for some years have had quite a bit to do with today's stresses in the global capital markets. Congress should be looking at this latest proposed blank check in that light as well as in the light of the risks involved in refusing to endorse it. That other great sound you hear comes from Washington, where there is a lot of debate on matters that have little relevance to the central issue.

The Nation

EXHIBIT VII

1/29/95
N.Y.T.

How Foreigners Invest, And Lose Their Shirts

By FLOYD NORRIS

FOREIGN investors have lost billions of dollars in Mexico, and the recriminations are flying. American investors want to know why their Government didn't warn them that the Mexican economy was sicker than it looked. The Mexican finance minister says things would not have gotten this bad if investors on Wall Street hadn't been so eager to send money. And as the United States Congress began balking at the Clinton Administration's proposal to bail out Mexico with $40 billion in loan guarantees, the Mexican stock market and the peso took another plunge.

So what else is new?

The history of foreign investing is littered with disaster stories. Governments fall, and their successors renege on their debts. Currencies are devalued. Bull markets collapse and in the rubble evidence of fraud emerges. The supposed experts who should have been on the lookout for problems were in fact too busy selling securities to pay attention.

It has long been a truism of investing that foreigners tend to buy at the top of almost any market. That is probably because they are not paying attention when a foreign market is cheap, only noticing it after prices have doubled and tripled and then rushing in. At first the waves of foreign buying push prices up even more, bringing in even more foreign money. But no boom lasts forever. And when rumors of problems begin to spread, foreigners are unlikely to be among the first to hear them.

Time after time in the late 19th century, British investors bought American securities, only to lose much of their money in a panic or in a bankruptcy that seemed to leave insiders unscathed. J. P. Morgan became the dominant banker in America in part because he was trusted by British investors to try to protect their interests. They needed protection from the likes of Jay Gould, who once kept control of the Katy Railroad (the Missouri-Kansas-Texas Railroad), despite the opposition of most shareholders, by printing the announcement of the annual meeting in an obscure Kansas newspaper. By the time the shareholders, most of them British, found out about the meeting, it was too late.

"A lot of money was lost by foreigners investing in the United States," said James B. Rogers, Jr., a former Wall Street money manager known for his inve··ing in risky for··ign markets. "But those who got it right made a great deal of money investing in this debt-ridden underdeveloped country."

In fact, the Mexican debacle is, in many ways, tame by historical standards, even by Mexican historical standards. As recently as 1982, the Mexicans

The Mexico disaster was tame by historical standards.

defaulted on promises to pay high interest rates on American dollars deposited in their banks, instead paying off the deposits in sharply devalued pesos. But this year, similar promises made by the Mexican Government have been honored, greatly reducing the losses for investors. And so far, the drop in Mexican stocks has not been tinged by scandal.

That is not always the case. Two decades ago, during a wild bull market in Hong Kong that drew in a lot of foreign money, some enterprising people took advantage of the swell by printing and selling counterfeit share certificates. Brokerage back offices were so overwhelmed by heavy trading that it was some time before they noticed the counterfeits. Soon after, the market crashed, and everyone lost money, whether or not they had been snookered into buying a phony certificate.

Just three years ago, a boom in India's stock market was fueled by phony bank certificates, which were traded like money. Profits vanished when the fraud was uncovered.

"There is always the risk of unexpected developments in any kind of investing," notes Barton Biggs, the chief international strategist for Morgan Stanley. "In international markets, the risks are compounded" because markets are not as open as the American market.

Foreign markets are also complicated by differences in accounting standards around the world. Standards can be surprisingly lax even in some major countries like Britain, where Robert Maxwell

carried out a massive fraud without his auditors noticing. And in some countries, there are no real audits at all. China had a brief stock market boom in 1993 despite a lack of reliable profit figures. And last year the Bank of China, a government-owned bank, sold $500 million of bonds to American investors. Although the bank's balance sheet looked good, it was not audited by any other accounting firm. Instead, the figures were certified by the bank's very own in-house accountants.

So far, that loan has not been a disaster for the lenders. But the willingness of investors to overlook the lack of an outside accountant is a sign that greed has gotten the better of them. "There are," says James Grant, the editor of Grant's Interest Rate Observer, "cycles of financial credulity just as sure as there are business cycles."

In the 1920's, Mr. Grant recalls in "Money of the Mind," his book on financial history, Ivan Krueger, a Swedish financier who dominated the world's match industry — that's right, the things you light candles with — borrowed huge sums of money at extraordinarily high interest rates. Although he used the best investment bankers, no one noticed that his auditing firm, a predecessor of today's Ernst & Young, had not certified his accounts. (In fact, they refused to do so because they could not confirm the figures.)

When Krueger's fraud was eventually exposed, the American investment bankers were blamed, even by Swedish investors. The investors said they had relied on the bankers to investigate Krueger. Max Winkler, a financial commentator of the time whose own warnings had been ignored, responded to those pleas by quoting, "Mundus vult decipi — ergo decipiatur." The world wants to be deceived — let it therefore be deceived.

Before the current Mexican crisis, there were in fact some warnings sounded. Last spring, Gert von der Linde, the retired chief economist of Donaldson, Lufkin & Jenrette, predicted the devaluation of Mexican currency. But his words were all but ignored. Indeed, most big Wall Street firms were eagerly recommending, and selling, Mexican investments right up until the peso fell.

Now American government officials say they saw the risks in Mexico and began warning Mexican officials as early as late summer. But they decided not to sound a warning here because they believed that it was important to support the Mexican Government and economy, particularly in the wake of the bruising ratification battle over the North American Free Trade Agreement.

There is plenty of precedent here, as well. In the 1920's American investors were persuaded to lend huge sums of money to Germany to help with its reconstruction and with reparations payments after World War I. The bankers who arranged the loans by selling bonds feared that Germany would default, and so did the American Government, but they kept quiet and emphasized how America would benefit from the loans, through increased trade. The fears, of course, were prescient.

Historically, the excesses of international markets have produced big profits and big losses, with the losses killing investors' enthusiasm for years or even decades. Now, President Clinton appears to be trying to avoid discouraging Americans from investing in Mexico.

Many Wall Street strategists argue that if Congress fails to approve the loan guarantees to Mexico, it will be playing Russian roulette with the hemisphere's economy. They say that America's responsibility to the economy far outweighs any concern about unjustly enriching foolish investors, whose bad bets on Mexico will prove much less costly to them if the bailout is approved.

That is an argument that grates on Mr. Grant, who thinks that the loan guarantees would be a bailout not of Mexico but of reckless investors. "This scheme has shown that Wall Street is not in favor of free markets," he said last week. "It is in favor of free bull markets. It is so much opposed in bear markets that it would like the Government to intervene to stop them."

All over the world, investors love to hear about a great opportunity, even if it doesn't exist.

PREPARED STATEMENT OF DAVID C. MULFORD

VICE CHAIRMAN, CS FIRST BOSTON INC. AND CHAIRMAN, CS FIRST BOSTON LTD., LONDON, ENGLAND

JANUARY 31, 1995

Mr. Chairman and Members of the Committee, I am pleased to be here today to testify on the issue of a U.S. assistance package for Mexico. I firmly believe that, having made the commitment to support Mexico, the Administration and Congress together must act, and act forthrightly, to provide the support that is necessary to restoring confidence in Mexico's economic financial viability. While I am sure that this Committee and Congress will made a decision that is in the best national interest, I am glad to have this opportunity to share with you some of my thoughts that are drawn from my years of experience at the U.S. Treasury and as a participant in the international financial markets.

Since a great deal of testimony has already been given, I would like to focus only on the most substantive points.

It is in our national interest to help restore confidence in Mexico, and particularly in its currency. This fact transcends the many questions which I know are troubling Americans as to why Mexico and the United States mishandled the devaluation of the peso and its immediate aftermath. The United States and Mexico are bound together by strategic, political, cultural, and economic interests, which in this case are reinforced by fundamental U.S. interests throughout Latin America, among emerging economies around the world, and by the continued functioning of global financial markets.

Over the last 10 years, Mexico has implemented a program of impressive economic and political reforms, which has substantially restructured Mexico's economy and greatly increased our trade and investment ties with Mexico. This has involved the removal of trade barriers and tariffs, extensive privatization, restructuring and deregulation, and reform of the financial system, including the creation of an independent central bank. NAFTA was a crucial landmark in the important process of integration between our two economies.

Many U.S. businesses have benefited from the emergence of Mexico as our third largest trading partner. The rise in exports to Mexico has created hundreds of thousands of new jobs for American workers. Those gains are now jeopardized by the downturn in the Mexican economy. In addition, imports from Mexico could soar, placing U.S. businesses at a comparative disadvantage in their home market, thereby threatening more jobs. U.S. economic growth and the U.S. trade and current account deficits will be adversely affected by a weak Mexico, and the damage could intensify if Mexico's crisis is allowed to spill over into other Latin American markets and beyond.

Besides the expansion of trade, Mexico has also succeeded in attracting large flows of direct and portfolio capital from international investors. Unlike the late 1970's and 1980's, when Mexico was heavily dependent on bank loans, these capital flows included portfolio equity and debt investment, direct strategic investment by businesses, and repatriation of Mexican capital from abroad. These flows have averaged nearly $14 billion annually over the past 4 years. Returning countries like Mexico to private capital markets has been a primary objective of the U.S. Government following the Brady debt restructuring of 1989.

We should be clear that the proposed guarantees are not a bank bailout. In the 1980's, banks ultimately took losses on their loans to Mexico, but only after nearly a decade of stagnant economic development in Mexico. This time the situation is entirely different. Investors have already taken huge losses. The challenge is how to convince them to reengage with new investment critically needed by Mexico to sustain its development.

Private capital flows have fueled reform and growth in Mexico. Among these private investors in Mexico are small companies as well as large U.S. corporations. For many smaller companies, their Mexican operations often represent a significant proportion of their business. Furthermore, a large number of individual U.S. investors currently hold around $20 billion in Mexican debt and equity assets, principally through mutual and pension funds. Who benefits from U.S. loan guarantees? The Mexican economy and the U.S. economy, not Wall Street or individual investors. These have already paid a high toll from the mishandled devaluation.

The fact is that, until Mexico's policy discipline weakened under the pressure of political uncertainties in the late months of the last Administration, Mexico represented a model for many developing economies. Now we face the reality of Mexico's crisis. Successful resolution will help stabilize global markets and ensure that developing countries will continue to have an uninterrupted access to private capital

markets. Otherwise, the lower flows of private capital will dampen their growth prospects, and governments (and taxpayers) around the world will be faced, once again, with the prospect of large aid flows that expand fiscal deficits.

The key to solving Mexico's present situation is the restoration of confidence. This begins at home in Mexico. First, a strong and stable currency and clear macroeconomic targets are essential in reestablishing Mexico's credibility. Pure austerity will not work, if it is not accompanied by a solution to the short-term liquidity crunch and supported by unquestioned monetary discipline. While a contraction in Mexican aggregate demand and the economy is needed to reduce the current account deficit to a sustainable level, an abrupt and excessive contraction under the current liquidity crisis will delay sound recovery in Mexico for years to come, adversely affecting the U.S. economy.

As the short-term crisis of confidence is overcome, the creation of a strong and stable peso should receive the highest priority. A number of models, including a currency board structure, have been successfully implemented in several countries. Such options need to be fully explored. This is the time to develop policies that work; and not the time to get hung up on ideology.

While the U.S. loan guarantee is vital for restoring investor confidence, its sole purpose should be to allow the Mexican government to retire short-term debt and replace it with longer-term obligations. This is not a debt restructuring, however, as some have suggested. There is no renegotiation with the existing creditors. Note that, so far, Mexico has been perfectly solvent, paying off all maturing debts on time. An appropriately structured loan guarantee need not impose costs on the U.S. taxpayer, and should be treated as a straightforward financial transaction.

The second main initiative for recovery of confidence is an aggressive privatization program in Mexico that captures the interest of world investors. This will attract capital and promote sustainable growth. No public enterprise should be kept off the potential privatization list. In an integrated North America, we should make our economies as competitive as possible.

In short, Mr. Chairman, I support the Mexican loan guarantee program because: (1) The President and the leadership of Congress have pledged the support of the United States; (2) Support will help restore investor confidence in Mexico and thereby prevent Mexico's liquidity problems from spreading to other emerging markets; (3) Support will halt a free-fall of the peso and a collapse of the Mexican economy, thereby limiting economic and political fallout for the United States; and (4) With imagination and cooperation on the part of Mexico, the U.S. Administration, and Congress, a program can be designed which will involve no substantial cost to the U.S. taxpayer. Under a proper structure, the benefits for the United States should clearly outweigh the potential risks.

PREPARED STATEMENT OF RUDI DORNBUSCH, Ph.D.

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JANUARY 31, 1995

This is not the first crisis in Latin America—the last one came as recently as 1982 when Mexico could not pay the bills and soon most of Latin America followed. The script is always the same, irresponsible lending by overconfident, overeager creditors and, on the borrower's part, major currency overvaluation combined with very risky poor debt management. The full Mexican meltdown is held off by the assumption that Congress will do what is in the national interest—support Mexican credit, help refloat Mexico, and forestall a worldwide bank run on emerging economies.

In mismanaging its exchange rate and precipitating a crisis, Mexico has done a great disservice to its own people and to private finance for emerging markets from Latin America to the post Soviet world and Asia. It would be a grave mistake to reward Mexico's policymakers by a quick-fix no-strings coverup that becomes the prelude to a replay down the road. It would be as much of a mistake to disregard the large fallout from a failure to shore up Mexican credit by loan guarantees.

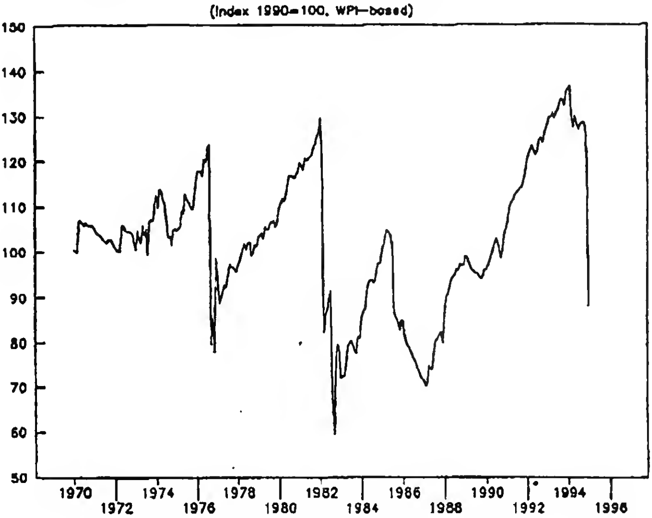
Loan Guarantees

Three questions need answers: Would a failure to put up a program produce significant damage in Mexico and beyond? Even if there were a big fallout, is it good policy to shore up countries that have mismanaged their finances? What should we ask of Mexico as part of the package? Each of these questions provides ammunition for Washington shoot-outs and endless academic debates.

Without a loan guarantee, Mexico will now default once again. We are almost all the way back to 1982. For the moment, using the last stabilization loan, Mexico is hanging in hoping for a miracle. Markets are not much help right now; sky-high interest rates are superficially attractive but, on second thought, it is clear that they will not be paid. A rock-bottom low peso is great because jumping from the basement window one can't commit suicide. But, on second thought, it means sky-high inflation and that leads to more depreciation just around the corner. Moreover, deep depreciation and high interest rates unravel Mexican politics and that is not a prospect cherished by investors. There is a stalemate and another default around the corner. There is nothing here to wet the appetitive of scavengers and bottom fishers.

MEXICO–USA RELATIVE PRICE LEVELS

(Index 1990=100, WPI–based)



A Treasury loan guarantee would limit interest rates required to support rolling and lengthening the Mexican debt and it would limit the peso depreciation at which some upside becomes a possibility. It avoids that Mexico falls into a political crisis where the old-fashioned left gains an opening to question the modernization and reform which genuinely occurred, even if they are now overshadowed by currency mismanagement, poison pill dollarization, and shortening of debts. Of course, Treasury loan guarantees could do miracles around the world. That is not enough reason to sprinkle them freely wherever a situation has been mishandled. In fact, if we were to rush in guarantees freely, the supply of crises around the world would turn up sharply.

But there is also a role, exceptionally, for the lender of last resort and an exception to the sound rule and presumption that people who mismanage have to live with the consequences. If an exception is warranted, we still have to attach provision for our risk, conditions that ensure more stability afterwards, and a lesson that this is not a service that comes free of charge.

The lender of last resort comes in not to reward a poorly managed debtor, but to avoid the spill-over effects of a credit system connected by confidence or contagion. A Mexican default and collapse will spill over to our own economy and bring down other economies, most immediately Argentina. The incidence is not primarily on the creditors who may well deserve the lesson and on Mexicans, but goes far beyond. With plenty of fragility in Latin America, once there is a crack in the system bank run mentality takes over. Very few institutions and countries can stand up to that. We also owe some loyalty to our product: Having preached open, modern, and deregulated economies, a failure to back up our model risks giving the advantage to the retrograde camp. Cardenas, Mexico's unreconstructed leftwing leader, is already on the march.

There is also an important concern in not undermining our foreign economic policy of the past 15 years. We have preached open markets in goods and finance. Collapse of Mexico's credit and growth would put in question the model of reform and market-based development that Latin America has practiced. The distinction be-

tween good reforms and bad currency management would have been glossed over and the entire model would risk falling into disrepute in the region and in Eastern Europe and the former Soviet Union. Enough reasons for the bold step to bolster Mexico with yet another support package.

What should we ask of Mexico? First and foremost, Mexico must put its finances in order. Mexico must, of course, submit to a full IMF treatment. It is just not right to say that most fundamentals are in place and all that is needed is a U.S. umbrella. The budget must be cut further and there must be assurances of tight money and a competitive exchange rate. Moreover, since Mexico is a repeat offender, we must go beyond IMF programs to a probation procedure linked to the U.S. support. There ought to be a formal advisory committee of outside experts from the United States, such as George Shultz put in place to supervise the Israeli post-stabilization period when U.S. support was a key ingredient for rebuilding that country's confidence. That committee would review the stabilization effort and report to the Administration and Congress if progress were unsatisfactory, in which case the guarantees should be suspended.

There is also the issue of privatization of Pemex. For expediency and quick progress this demand needs to be made off the stage, but it must happen. Mexico does have assets, why take our money if Mexico can ultimately mobilize its own assets? Lets not make too much of Mexican sensitivities. We in the United States also have political hot buttons, so why exaggerate the Mexican difficulties. In fact, regularly bailing out Mexico is quickly becoming one of them. Thus, if Mexico needs help, let us insist that Pemex goes on the block to take very soon the place of our guarantees.

In passing, we need to comment on non-solutions to Mexico's problem. One is the notion that this is a good time to introduce a currency board—convert Mexico's monetary base into dollars and be done, once and for all, with the issue of currency stability. We might put the point differently—make Mexico an Argentina! Right now the comparison favors Argentina, but who doubts that Argentina is on the verge of a banking crisis and may only narrowly escape. A currency board makes sense in an economy that is *de facto* fully dollarized as Argentina was after the hyperinflation. In a country where dollarization is incomplete and demand deposits are substantial, it is very complicated and expensive. But even that is not enough. The accompanying *essential* reform is 100 percent reserves for the banking system. In such a setting, there is no need either to shift from pesos into dollars or from deposits in Buenos Aires to Miami. Such a scheme is totally stable, but it is, of course, radical change in the financial structure that cannot be implemented overnight.

More questionable, by a wide margin, is the notion that exchange rates do not matter for trade flows and that, accordingly, the peso should be rolled back to 3.5 as if nothing had happened. That view conveniently omits that Mexico had an extraordinary problem—high real interest rates, a huge deficit, and no growth before the present calamity started. The fact that the devaluation came too late, in uncontrolled circumstances and was botched, does not mean that it was the wrong policy. Going back to that situation, even if one could, would just set the stage for creating the initial crisis all over again. And let there be no doubt, Mexico was not growing, nonperforming loans were rising, real interest rates were exceptionally high—the real interbank rate averaged more than 12 percent since April. Moving back to 3.5 would make the balance sheets of those who bet on the peso look better, but the chances of putting some order and growth would be far less.

In the 1920's, Churchill made a name for himself by insisting on the return of sterling to the prewar par. The City liked it, but rolling back cumulative inflation proved too much. With the ensuing depression, Britain never recovered. The policy contributed to a weak and unstable interwar economy. In Mexico, too, rolling back wages and prices to undo the overvaluation of the past 4 years will not happen by the stroke of a pen. Hot money would be bailed out but the productive economy would be strained.

We next turn to a review of what happened in Mexico.

What Happened in Mexico

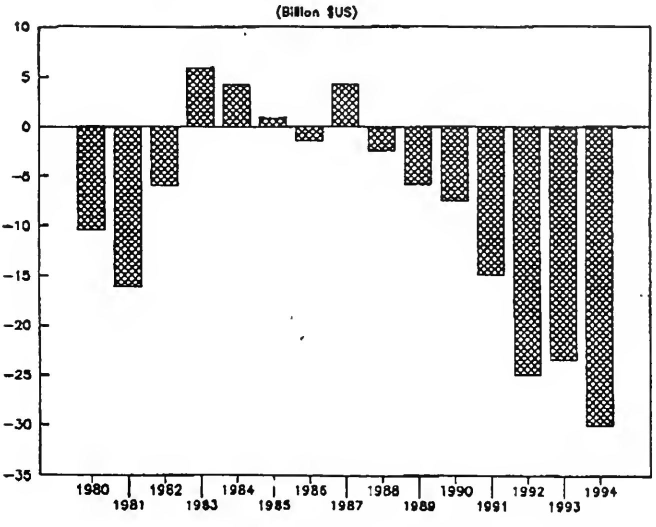
The crash of the Mexican peso is just one more example of the cycle of exuberant optimism followed by collapse and bottomless skepticism in Latin American finance. As long as the music goes on, more and more ignorant investors are pulled. And with the prospects so bright, more and more promoters raise capital to take investors for a ride on the bubble. In the end, there is always a crash—it takes much longer than one thinks and then it happens much faster than one would have thought. A country that, only a moment ago, was basking in the glory of reform and prosperity falls straight into bankruptcy.

Following a borrowing spree in the late 1970's, Mexico last crashed in 1982. Debts to commercial banks around the world went into default; the peso was devalued over and over again in an attempt to gain a trade surplus to meet the demands of creditors. But even as the currency went down, inflation exploded. That vicious cycle of inflation and depreciation came to a peak with inflation well above 200 percent. Under the pressure of events, reform and stabilization became the central objective. Much good was done: privatization, trade liberalization, including NAFTA, deregulation, and budget balancing, including fiscal reform.

External confidence recovered, money started coming, external deficits ballooned. With easy access to financing and much of the domestic agenda accomplished, reducing inflation to U.S. levels became the central preoccupation. Depreciation of the currency was kept far below the rate of inflation; that helped slow inflation, but it also meant an increasingly uncompetitive trade position. At the outset, that could be rationalized by renewed access to world capital markets and the rewards of a reformed and stabilizing economy.

Somewhere along the way a U-turn must come to restore competitiveness, otherwise the currency ultimately goes over the cliff. By 1993, Mexican producer prices had risen *in dollars* by over 45 percent compared to prices in the United States. An overvaluation of at least 25 percent could be discerned. Growth slowed down in 1993. In 1994, election year spending made for an upturn as did a very rapid rate of credit creation—upward of 25 percent over the 12 months to August—by the "independent" central bank. Yet real interest rates were extremely high when measured by rates on commercial bank loans, and the external balance shifted toward a massive deficit.

MEXICO: CURRENT ACCOUNT



All the symptoms of a troubled financial situation were in place. Clearly the peso had become overvalued but Mexican leaders refused to acknowledge the facts and foreign investors were lulled into holding on to exposed positions. Superior fiscal performance was, of course, a strong point in explaining why Mexico was quite uniquely attractive.

Table 1. Mexican Macro Data

	1990	*1991*	*1992*	*1993*	*1994*
Per Capita GDP (%)	2.5	1.6	0.8	−1.6	0.8
Current Account[a]	−7.5	−14.9	−24.9	−23.4	−27.9
Debt Ratio[b]					
Domestic	18.7	15.2	8.8	5.5	
External	30.7	24.1	20.8	19.0	

[a] Billion $US.
[b] Percent of GDP.

But the government had political priorities that conflicted with reality and perhaps even fooled itself that the problems would go away or the financing would become easier. The rest is history: Reserves were run down to unmanageably low levels, debts were dollarized, maturities were shortened—just keep the music going so nobody finds out that the emperor has no clothes. Of course, these very steps to try to squeeze an extra year of life out of a moribund strategy explains the extreme severity of the following crisis.

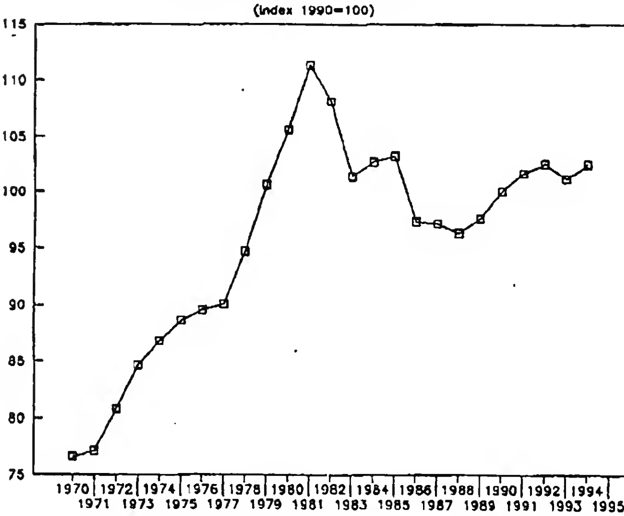
Mexico's policymakers rationalized that real appreciation was unproblematic: NAFTA would bring direct investment and trade opportunities. Deficits were large now but would be small in the future and, in any event, money was no object since investors had fallen in love with Mexican stocks and T-Bills. Overvaluation turned problematic when the upcoming 1994 election brought with it the possibility of changes in economic strategy or a show of weakness of the official party.

Indeed, politics turned nasty (Chiapas, the assassination of the candidate, and more). But no day passed without fresh assurances to the investors that all was well: The peso would never be allowed to fall. The foreign loans kept coming, but at higher interest rates. High interest rates and lack of competitiveness increasingly strangled growth. No growth and a gigantic external deficit—some 6 percent of GDP—made for a classical prediction: The peso would yield.

Mexico's per capita income today is still 5 percent less than it was in 1982, at the time of the last crisis. (See Figure). The easy money is gone, and real income will be falling further. Salinas' brilliant reforms were about to put Mexico on the path of prosperity; his utterly misguided currency experiments instead plunged the economy into economic and possibly political turmoil.

MEXICO: PER CAPITA GDP

(Index 1990=100)



In the aftermath of reserve depletion and a botched realignment, massive selling, redemptions in funds, and forced liquidation with price collapses chased yet further redemptions. Markets in pesos and Mexican credits vanished—vast bid-ask spreads, illiquidity, and a downward spiral of massive redemptions in mutual funds forcing liquidation on their part *at any price*. "Meltdown" is the only description of the process we witnessed over the past few weeks. The financial chaos, the sheer lack of a market, and the inability to raise even a few hundred million dollars in new credits conjure up the image of a gigantic fraud—Mexico had never reformed, there was no substance, the other shoe (whichever that might be) was about to fall.

Of course, that is an extreme and totally unwarranted assessment of where Mexico has come. A better analogy is with a company where the engineers have developed great technology, the workers have done a special job in raising productivity, and the sales people have excelled in developing markets but, while nobody was watching, the CEO and the CFO were playing the markets, speculating in currency, and rigging up a gigantic loss that overshadows all the gains made in the years of

reform. Mexico had an Orange County problem, to draw an analogy with recent financial scandals in the United States.

After the Guarantees

What comes next? Of course, there is pervasive disillusion with portfolio investment in Latin America. The dupes are leaving and the scavengers are taking their place. Net flows of money, however, are sure to be far, far less than they have been in the past few years. Current account deficits in Mexico and elsewhere will come down.

A U.S. rescue package assures that the panic mentality is replaced by the emergence of ordinary markets, more reasonable—though very high—interest rates, and the development of at least some maturity structure to Mexico's debt. Of course, normalization of credit is only a first step on the way to normality. The immediate next issue is what interest rate and exchange rate policy to opt for. Chile's precedent—following the collapse in the early 1980's under conditions very much like Mexico's in the recent past—is instructive. Chile focused on a highly competitive exchange rate and a strong external balance; inflation was taken very seriously but never was allowed to become an obsession to the point of making recession for the purpose of disinflation or, even worse, risking overvaluation. In Mexico, a realistic currency policy starts with a peso at 5.5 not 4.5 pesos to the dollar.

Mexico needs a super-strong external balance if there is to be growth and financial stability. A more moderate level of the peso has the immediate attraction of satisfying the partners in wage-price agreements, but surely means slow growth and high real interest rates. That combination, inevitably, means the economy will get even more vulnerable and politics will be awful. Anyone who says "politically impossible" has to be reminded that this argument was used over the past 3 years to deny reality and should today be thoroughly discredited.

In this year, Mexico will, of course, suffer a serious recession—no growth must be taken for granted and a decline of only 5 percent in output is optimistic. The budget is being cut very seriously and that reduced demand. Moreover, investment will decline very steeply under the pressure of no credit and/or super-high real interest rates. Finally, consumer confidence is bound to be very seriously rattled and that means less spending. Sectors such as construction and machinery will show pervasive bankruptcies. The fallout of mismanagement has not even started and, in this respect, the parallels with 1982 are totally appropriate. Mexico will honor its debts, this time round, but it most definitely will not escape a quite difficult period of restructuring.

When can Mexico expect a return to business as usual? Not for years; there will be inflation, recession, bankruptcies, and workouts for quite a while. Easy money won't come back for quite a while and direct investment, while tempted by increased competitiveness, is also discouraged by political instability. It is worth remembering that direct investment has not been the major part of financing in the past. It will be the major source of finance in the years to come and that means, even with a doubling which is hard to get, there won't be much. In 1993, for example, a current account deficit of $23 billion had as its counterpart only $4 billion in direct investment and all the rest was money ranging from lukewarm to hot. Thus, unless Mexico opts for and succeeds in getting a very competitive exchange rate, external constraints will steadily limit growth.

U.S. loan guarantees avoid the worst, but they are no panacea. Specifically, they cannot avoid that Mexican spending must come back in line with incomes, that interest rates will be high, and real wages low. In that sense, Mexico is back to 1982. All the reforms will help on the way up, but the prospects are overshadowed by the destructive currency play that now needs to be paid for. In looking ahead, though, we must recognize that Mexico has made great progress in the past decade; the country now must build on these foundations to try to recreate confidence, recovery, and, ultimately, prosperity.

Mexico is by far the worst hit country in this crisis. It was more cash dependent, it abused investor confidence more, and had less substance in the till when the run started. Mexico will suffer most; Mexico will enter the next century far poorer than it was two decades ago. But all of Latin America is now on probation. The panic is off, but the easy money is off, too. Current account deficits will be far smaller simply because new money will be very hard to get. For some countries that is bad news.

Argentina comes out in many ways as a winner. Sure, there, too, interest rates will be high and growth will come down. Argentina has enjoyed growth, overvaluation, reform, and now will enter a period of sharp slowdown and realism. The peso will hold, President Menem will be reelected because he succeeded where Mexico failed, but growth will be modest. But the Argentine peso has stood up well in

this baptism of fire. Many expected the peso to go under but, owing to the ingenuity and sheer energy of finance minister Cavallo, it is still there and it is there to stay at 1:1 with the dollar.

Brazil, with its new economic team and a tired stabilization plan, also faces reality. Brazil's President, like every other Latin President, loudly proclaims that, "We are not like Mexico." True, but Brazil is not without risks. Brazil does not have the credit dependence of Mexico or Argentina. At the outset of a new government and well into a stabilization plan, second wind is now essential. Avoiding currency overvaluation is the foremost priority, fiscal correction is paramount, and massive privatization is urgent. It is time for a more serious fiscal stabilization, a more aggressive privatization, and an early realignment of the currency to avoid that a year down the road Brazil develops the Mexican disease.

Brazil can grow and stabilize at the same time but only if the government now focuses on giving the "Real Plan" a new and more aggressive definition, shifting from an election device to true stabilization. Mexico's crisis and the Treasury rescue provide Brazil with the warning and the reprieve to do just that.

Latin America has fallen behind and the crisis sets it back further. It is high time to go beyond the rhetoric and assure economic policies that are both stable and sustainable. Containing inflation is very important, assuring growth is at least as important. Coping with inequality by economic growth is far preferred to another relapse into failed recipes of populism and statism which is always in the wings.

PREPARED STATEMENT OF GUILLERMO A. CALVO, Ph.D.

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JANUARY 31, 1995

I. Introduction

In this note I will, first, present a brief diagnosis of the Mexican situation arguing that a situation of fiscal imbalance prevailed before devaluation, and that the crisis was aggravated by the existence of a large stock of short-maturity debt and highly liquid bank deposits; second, I will discuss the rationale and necessary conditions for a successful U.S.-sponsored rescue package; and, third, some alternatives will be explored.

The paper will argue that loan guarantees are attractive if they are accompanied by credible conditions that possibly go beyond the ones mentioned by the Administration. Alternatively, Mexico could offer loan guarantees not involving the United States, which will likely need the collaboration of powerful and credible third parties, making it a poor substitute for the Administration's package.

II. The Mexican Crisis: A Diagnosis

Mexico has displayed a strong commitment to market-oriented reform and impressive fiscal restraint. This partly explains the large amount of foreign capital that flowed into Mexico since 1989. However, a significant share of those flows are likely to have been due to low interest rates and recession in the United States. Thus, as the latter conditions reversed, loans to Mexico tended to dry up, and Mexico's interest rates showed an upward trend.[1]

Furthermore, a capital-outflow process was set in motion during 1994, partly prompted by Chiapas and other tragic events, and partly prompted by the authorities' distaste for the high interest rate. Authorities tried to compensate by issuing *Tesobonos*. *Tesobonos* are Mexican public sector liabilities indexed to the U.S. dollar but paid in pesos and, thus, are better insulated from a devaluation than a straight peso bond (like the *cetes*).[2] However, interest rates were not attractive enough, and investors started to flee out of pesos and into dollars, leading to a sizable drop in Mexico's international reserves.

Toward the end of 1994, the central bank faced at least two options: (1) increase interest rates, or (2) devalue. Mexico chose the second option hoping, I would like to assume, that after devaluation interest rates will fall, like had happened after the recent European devaluations.[3] In the process, Mexico's competitiveness in

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[1] See, for example, G.A. Calvo, L. Leiderman, and C.M. Reinhart, "Capital Inflows to Latin America: The Role of External Factors," IMF *Staff Papers* 40, March 1993, pp. 108–51.

[2] A bond indexed to the dollar does not guarantee full insulation from devaluation risk because indexation is not perfect, and there is always the risk that bonds are repaid at some arbitrary "official" rate.

[3] It could be argued that the only realistic option for Mexico was to devalue because higher interest rates would have either failed to stop capital outflows, or would have deteriorated the

international markets would improve and growth would, at long last, begin to materialize.

Unfortunately, this was a major policy mistake for two reasons. In the first place, *Tesobonos* are denominated in U.S. dollars and, therefore, their dollar value is not affected by the devaluation. Thus, the pressure on international reserves pointed out above continued unabated and, actually, increased since the financial community took devaluation as a breach of an implicit promise to defend the peso. In the second place, *Tesobonos* are of short maturity, implying that holders have the right to get the *principal* back in a relatively short period of time. The amounts are staggering and exceed Mexico's international reserves by a wide margin.

Why did Mexico allow itself to be put into such a vulnerable financial position? I can only offer some thoughts. One plausible reason is that it may have been extremely costly to float longer-term peso-denominated, or even dollar-denominated, debt. This may have been due to the weakness of the ruling party, or to the perception that the program was "unsustainable" and a substantial public sector adjustment, e.g., fiscal adjustment, should yet take place. I will elaborate on this possibility next.

As many observers point out, fiscal accounts in Mexico (especially the non-financial public sector) appeared to be, on the whole, balanced. So, the question arises, why would more adjustment be needed? A partial answer is that fiscal balance prevailed partly *because* the Mexican government floated short-maturity bonds. Had the Mexican government floated longer-term bonds, their interest rates would have been higher, leading to a weaker fiscal stance. Thus, to some extent, fiscal imbalance was concealed by floating short-maturity bonds. Furthermore, the program gave rise to a current account deficit and an expenditure boom which likely generated larger fiscal revenue. Since the boom is unsustainable, so are the associated fiscal revenues. Hence, another partial answer to the above question is that the fiscal deficit would have been larger if it had been adjusted for unsustainable tax revenue.

In sum, Mexico's difficulties are partly explained by the existence of fundamental fiscal imbalance, concealed by issuing short-maturity bonds and by unsustainable fiscal revenue (associated with large current account deficits).

Fundamental imbalances of the magnitude observed in Mexico, however, cannot explain the extent of the crisis. The latter is, in my view, a result of the financial vulnerability referred to above. The pressure on the peso is enormous when maturing bonds far exceed international reserves. Furthermore, the whole political equilibrium is shaken. For example, Mexico is likely to take much harsher fiscal measures than it had intended before the crisis. The latter is sound economics but it certainly affects political equilibrium.

Financial vulnerability was not restricted to the public sector. Another important destabilizing development was the large increase in bank deposits that took place since 1990. The dollar equivalent of bank deposits (plus cash outside banks, i.e., M2) more than doubled during the period from 1990 to 1994 and, before December 20, represented about $110 billion. Those deposits are highly liquid and can leave the banking system in a very short period of time, provoking a banking crisis unless their value is deflated, through currency devaluation or open confiscation, to levels that can be supported by the central bank (with international reserves, which were practically nil after taking into account short-term government obligations).[4] This situation further contributed to deepening the financial crisis and placed the whole economy in the hands of "jittery" investors whose actions are hard to predict.

Therefore, an initial run against the peso may have escalated into a stampede as investors perceived a possible crack in the political apparatus and a collapse of the domestic financial system.

III. Loan Guarantees

1. General Discussion

The rationale behind loan guarantees is very simple. If we believe the Mexican government will follow policies that are sustainable in the long run, then the package is a way of showing private sector investors that the United States stands behind the program. This will make investors more willing to take Mexico's long-matu-

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fiscal stance so much that the government would have been unable to place its debt for solvency, not just liquidity, reasons.

[4] The low level of reserves to support M2 stems from the elimination of legal reserve requirements on time deposits. This is a clear policy mistake in exchange-rate-based stabilization programs because the system as a whole lacks a "lender of last resort." I suspect this measure was adopted in order to lower interest rates charged on loans to the private sector and, thus, stimulate investment and growth.

rity debt at reasonable interest rates and, given that Mexico's policies were assumed to be feasible, there may never be a need to rely on such guarantees.

As pointed out above, however, there are good reasons to question the strength of Mexico's fiscal stance. Thus, the loan guarantees will have to be complemented by an adjustment program, which explains the role of the IMF in this respect.

Skeptics could still question the need for the rescue package. It could be argued, for example, that if Mexico agrees with the IMF on a credible adjustment program, the need for a rescue package from the United States is greatly diminished because, as a result, interest rates on long-maturity Mexican debt would fall dramatically. I believe this is a sound argument which, however, disregards a very important fact, namely, that Mexico's international credibility in financial markets may take a considerable length of time to fully recover. In the meanwhile, interest rates will stay high and threaten the success of politically-feasible adjustment plans.

A successful rescue-package-cum-stabilization program should result in a significantly higher dollar wage in Mexico (compared to present-day level) which, among other things, would lower the incentives for illegal immigration. It is worth noting that, from the U.S. standpoint, it is of little relevance whether, say, the stabilization program is designed around an exchange rate of 3.5 or 5.5 pesos to the dollar, as long as the dollar wage is reasonably high, because most of the Mexican debt obligations held by U.S. residents is denominated in dollars.

2. CHARACTERISTICS OF LOAN GUARANTEES

In order for loan guarantees to be effective, Mexico should be able to rely on them in their entirety since the beginning of the program. This is so because debt maturing in 1995—a sizable share of which will have to be rolled over—is very large. *Tesobonos* alone represent around $30 billion. Under these circumstances, it would be dangerous, for example, to impose quantity constraints limiting the access to those guarantees on an annual basis. This kind of limiting package may result in the worst of both worlds: It may not reassure investors, thus keeping interest rates high on Mexican debt or making it impossible to roll it over. Furthermore, this situation may evolve into debt default and a costly deal for the U.S. taxpayer.

Unfortunately, front loading would leave the United States a bit at the mercy of Mexican policymakers. This is so because after the loan guarantees are utilized, the United States would have no control on Mexican policy *unless* some kind of "conditionality" is attached to the rescue package.

Rescue package conditionality will have to be different from that in a typical IMF program. In the latter, disbursements are typically made conditional on past performance implying that, in general, IMF programs cannot be heavily front loaded. In contrast, as noted above, loan guarantees require front loading and, thus, there may not be enough time to observe performance before the guarantees are activated.

I do not think there is a simple solution to the conditionality problem. For example, the proposal of using as a collateral future oil revenues in case of default may be very hard to implement. Default normally occurs when a country has reached a limit beyond which citizens are not willing to take any further sacrifices. How would the United States, under those circumstances, extract the "pound of flesh" (through the impoundment of oil revenue) that Mexican authorities would otherwise not be able to enforce in a democratic environment?

On the other hand, collaterals could be used to implement "penalties" if Mexico departs from pre-specified policy commitments. For example, part of the collateral may be attached by the United States if Mexico's fiscal deficit exceeds a given amount. The advantage of this procedure is that the United States does not have to wait until Mexico reached the "bottom of the barrel" before attachment takes place. However, preemptive confiscation of oil revenues may trigger larger fiscal deficits, setting in motion a dangerous penalty-fiscal-deficit spiral. Needless to say, these procedures cannot be administered by the United States alone, and would require the good services of an international court or, at the very least, international financial institutions.

These difficulties should be faced head on to avoid a future escalation of guarantees and the emergence of open default. The rescue package should, therefore, be as specific as possible on how the above-mentioned difficulties will be dealt with. Good intentions and mere descriptions of escrow accounts are not enough.

IV. Alternatives to U.S.-Sponsored Loan Guarantees

Given the short maturity of Mexican debt, absence of loan guarantees will make it very unlikely for Mexico to be able to service its debt during 1995. Actually, debt difficulties will become already evident in the next few weeks.

Under the present circumstances, Mexican debt is held by a myriad of bondholders, instead of a large but manageable number of banks. Thus, debt reschedul-

ing would be enormously complicated if agreement has to be reached between Mexico and its creditors. Therefore, I believe that Mexico will have no other option but to (1) reschedule unilaterally without negotiating with its creditors, or (2) offer loan guarantees that mimic those involving the United States, possibly with the help of credible third parties.

Alternative (1) could have devastating consequences. As it happened after 1982, capital to Mexico will come to a halt and capital flight will be rampant. High inflation will set in, trade with the United States will be seriously disrupted, and illegal immigration could reach critical levels. In addition, other countries in Latin America may be subject to serious strains. Many countries in the region have implemented radical market-oriented reform but are still vulnerable to financial crisis. The Mexican debacle may lead speculators to launch another fierce "attack" on some of the other currencies in the region, wreaking financial chaos.

Nothing good could come out of such chaos. Reforms will be rolled back, markets will close for the United States, and the dream of a unified, efficient, and peaceful Western Hemisphere may be shattered for years to come.

Much more benign is alternative (2) in which Mexico sets up loan guarantees singlehandedly putting as collateral, for example, future oil revenues. However, the credibility of such an arrangement is open to serious question because, in contrast with U.S. loan guarantees, the present arrangement will involve a sovereign nation (Mexico) and a myriad of bondholders with little political clout. Thus, ways should be found for Mexico to voluntarily give up its rights on oil revenue, for example, to ensure debt service. The arrangement should involve credible, and politically palatable, international financial institutions, like the Inter-American Development Bank.

V. Final Words

Mexico disregarded early warnings of fiscal and financial stress, and lowered the cost of servicing domestic debt by issuing short-maturity and dollar-denominated public debt instruments.

Problems started to surface as capital began to flow out. Capital outflows are partly due to internal political difficulties, but are also grounded in external factors. Economists have been warning Mexico and other emerging markets that they should get ready for a reversal of capital flows as international interest rates went back to normal and the United States started to recover from the slump.

Furthermore, the devaluation was largely ineffective in stemming capital outflows because *Tesobonos* are denominated in dollars, in addition to making it clear to the international financial community that policymakers in Mexico had a poor, if not naive, understanding of present-day capital markets, especially given the large and unbacked stock of bank deposits.

On the other hand, Mexico is Mexico and policymakers can be replaced. The economy is basically sound and needed additional reforms are within reach. Nevertheless, international help is required to avoid that a liquidity problem develops into a solvency problem. In this respect, U.S.-sponsored loan guarantees have the potential of being highly effective.

Loan guarantees are not without risk for the U.S. taxpayer. Thus, conditionality is critical and, unfortunately, not easy to implement. What we know about the package is still vague on how difficulties associated with implementation of conditionality clauses will be handled. Once a satisfactory solution is found for the conditionality hurdle, however, the U.S.-sponsored loan guarantees look like a win-win strategy, especially when some probable alternatives are taken into account. To be sure, out of this arrangement some individuals may win more than others, but that is no valid argument against loan guarantees as envisioned in the U.S. rescue package.

Alternatively, Mexico could ensure payment against future oil revenue without the help of the United States. However, to make this arrangement credible it might be necessary to involve some neutral and influential party, like the IADB, which can be counted on for insuring that Mexico will honor this type of commitment.

POLITICS & POLICY

Debate on Mexico Package Turns Into Early Test For GOP Presidential Hopefuls Dole and Gramm

By JOHN HARWOOD
And JILL ABRAMSON
Staff Reporters of THE WALL STREET JOURNAL

WASHINGTON—The fight in Congress over salvaging the Mexican peso is also a stage for the emerging battle in Republican presidential politics.

Sen. Bob Dole's support for Mexican loan guarantees reflects not only his institutional role as majority leader, but also his position as a favorite of the GOP's traditional base in the country's business and financial establishments. By contrast, the potshots that Sen. Phil Gramm has been taking at President Clinton's rescue proposal underscore his backbencher's freedom to court the GOP's newly muscular populist wing. And however their minuet plays out on Mexico — Mr. Gramm still holds out the possibility of backing a properly conditioned package — the issue demonstrates how both men will have to balance the interests of voters and campaign givers in the run-up toward a 1996 primary season that will require war chests of some $20 million or more.

Sen. Bob Dole

Supporting Mr. Clinton's rescue proposal "could help your fund-raising and lose you the nomination," says GOP strategist David Keene, who worked for Mr. Dole's 1988 presidential campaign. "It could help you in the New Jersey and Connecticut primaries, where everybody has bonds, but it's not going to help you in Iowa or anywhere else."

"It clearly is harmful" adds Ralph Reed, executive director of the Christian Coalition, whose members helped fuel the GOP takeover of Congress. "There's a populist, grass-roots undertow that has reached tidal-wave proportions since the November elections. It's rallying cry could be, 'Cut their peso and send them home.'"

The Mexican-aid furor arises as the two prospective candidates take on the immense financial burdens of the front-loaded 1996 GOP primary calendar. Both men, who backed the North American Free Trade Agreement and the world-trade pact, have deep roots in the business community. While raising millions of dollars for his own political campaigns, Mr. Dole also heads one of the largest political-action committees, Campaign America, which raised $8.6 million in the 1993-1994 election cycle, and leads a charitable foundation that accepts corporate contributions. Meanwhile, Mr. Gramm, who recently completed four years as chairman of the National Republican Senatorial Committee, where he helped raise $64.1 million, has received large contributions from an array of corporate PACs.

But the pattern of their contributions also reflects different bases of support. Mr. Dole is more reliant on backing from institutions and wealthy individuals. PACs financed some 50% of his 1992 re-election campaign, for example, while just 4% of his war chest came in individual donations of $200 or less. From 1987-1992, according to an analysis by the Center for Responsive Politics, the Kansas Republican raised nearly twice as much money from the securities and investment industries as from small donors.

By contrast, Mr. Gramm, with his harder-edged populist rhetoric, received some 31% of his 1990 re-election treasury from small individual donations and just 10% from PACs. In the 1987-1992 period, the Texan's small-donor support dwarfed his securities and investment contributions by a factor of 20.

'Defining Moment for Gramm'

And now, as the 1996 campaign heats up, Mr. Gramm may have an opportunity to ride the populist wave that he avoided in earlier trade debates. "Mexico could be a defining moment for Gramm," says Republican strategist William Kristol, himself an opponent of the Mexican bailout.

"It could be the moment when he defies conventional wisdom and the establishment, and goes with public opinion on sound grounds," Mr. Kristol says, as opposed to the insular appeal to "economic nationalism" voiced by former Republican presidential challenger Pat Buchanan and the Ross Perot. Instead, Mr. Gramm grounds his objection on the fear that guaranteeing $40 billion in loans simply makes no sense unless Mexico reforms its monetary system to prevent the current crisis from repeating itself.

Mr. Dole also has left himself room to maneuver away from the rescue if congressional support, which has eroded substantially in both parties in recent days, collapses altogether. But he won't do so easily. Dwayne Andreas, chairman of Archer-Daniels-Midland and one of Mr. Dole's biggest financial backers, says: "I feel very strongly that we should do the $40 billion deal. The alternatives are infinitely worse. It's an earthquake." Pat Choate, a onetime adviser to Mr. Perot who debated Mr. Andreas during the fight over Nafta, adds: "Dole is philosophically attuned with the forces that want the bailout."

Campaign-finance considerations aside, Mr. Dole, like House Speaker Newt Gingrich, has other strong reasons to cooperate with Mr. Clinton on the rescue. With Republicans controlling both houses of Congress for the first time in 40 years, both leaders are under pressure to prove that they can govern. And the pressure is especially acute on a foreign-policy crisis in a neighboring country.

Speech by Dole Yesterday

At Mr. Clinton's request, Mr. Dole resumed efforts to make the case for the rescue in a speech yesterday. "We believe there's a way to do it to minimize the risk to the American taxpayers, to minimize the risk to American jobs," the GOP leader told the American Hospital Association. "Some would say, 'Who cares, it's their problem.' I wish it were that easy."

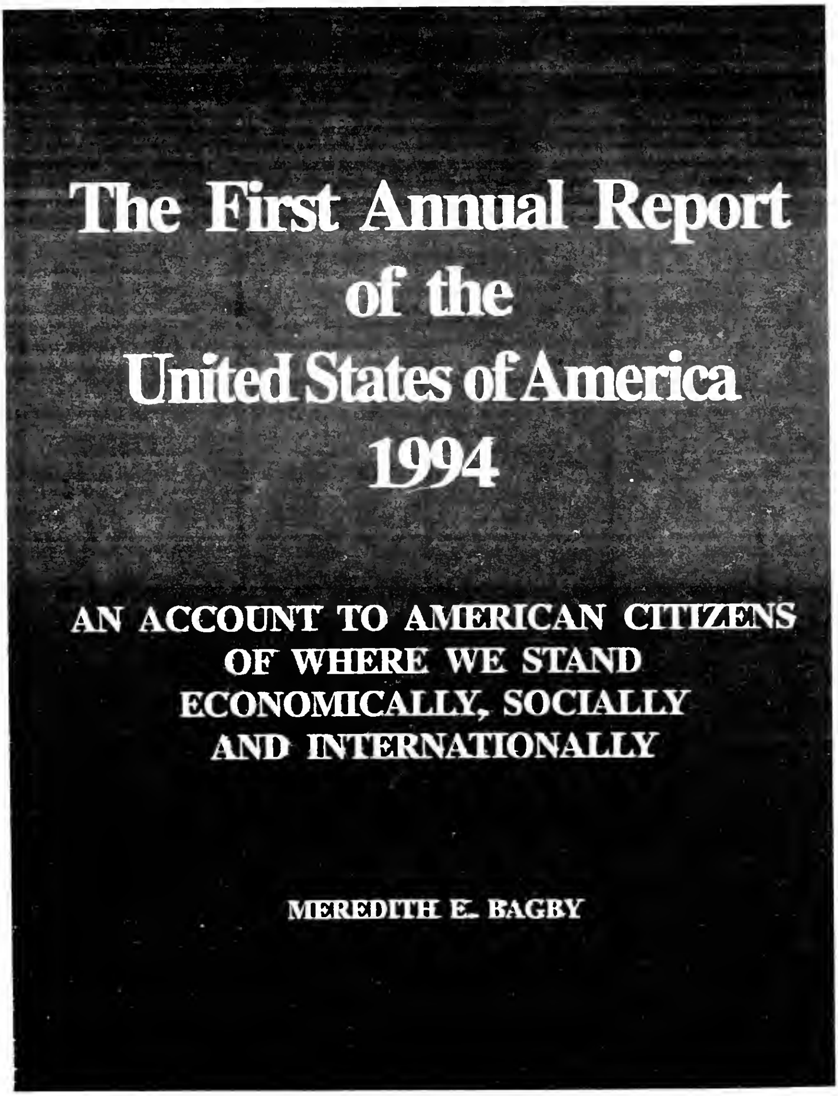
To bolster that argument, the administration yesterday released "a declaration of support" signed by such establishment GOP figures as two former presidents—George Bush and Gerald Ford — and three former cabinet secretaries—James Baker, William Brock and Carla Hills. Messrs. Dole and Gingrich also want governors from border states, such as California, Texas and Arizona — themselves big players in the 1996 primaries — to help pull wavering Republicans such as Mr. Gramm into line. "I assume he will support" the administration's ultimate proposal, Mr. Dole said yesterday.

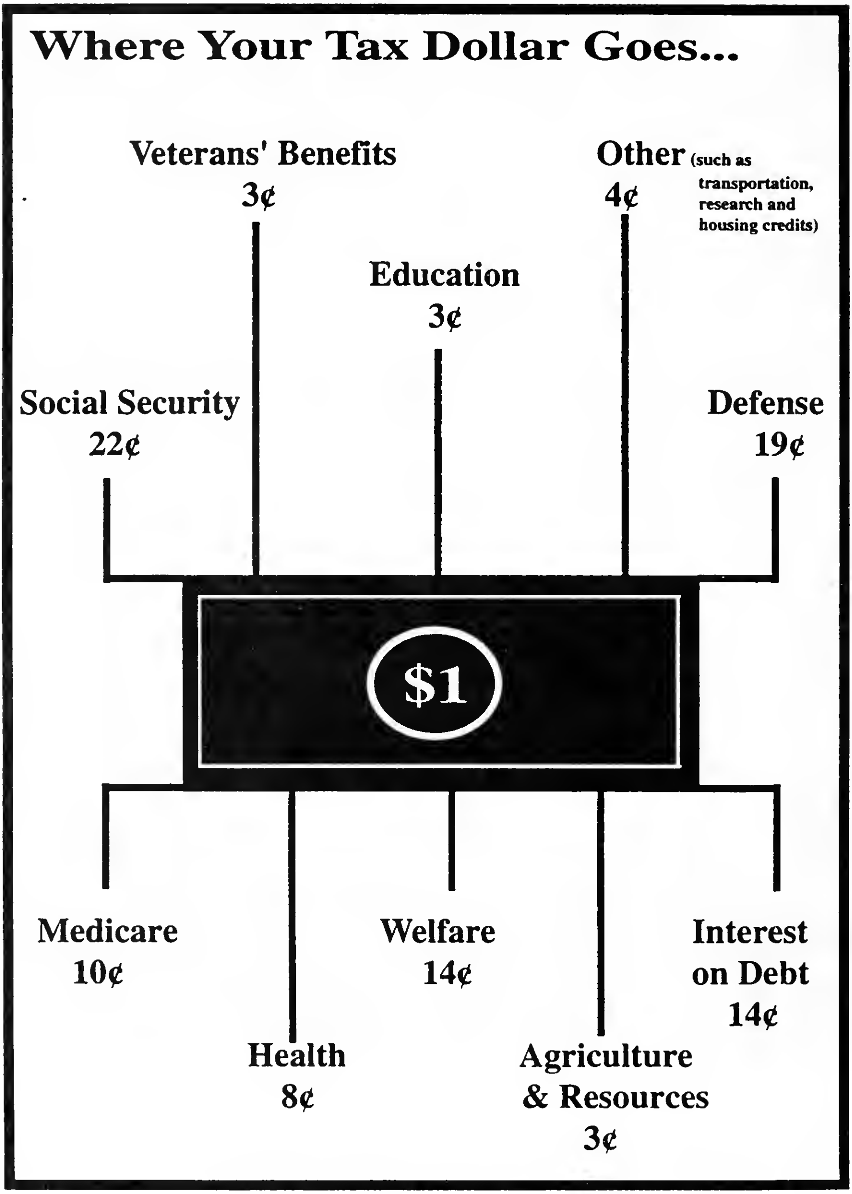
And indeed, that's just what the GOP's most aggressive populist voices for economic nationalism are worried about. At the moment, Mr. Buchanan says, "This is the first complete rout of the governing elite since the League of Nations went down to defeat" after World War I. But with strong support from the White House, advocates of the rescue on Wall Street and in the business community generally could yet call in past IOUs to shore up their position in both parties on Capitol Hill.

Sen. Phil Gramm

If that happens, the reverberations could be felt far beyond the confines of GOP presidential primaries. At a time when the new Congress is moving toward deep budget cuts, warns Mr. Keene, guaranteeing $40 billion in Mexican loans exposes Republicans to the same deep-seated voter anger that consumed Democrats last fall, fueling prospects for a powerful third-party candidacy in 1996.

Ordinary Americans "have already rejected one party, and they're looking askance at the other," says the veteran Republican consultant. Instead of Mexican stability, he argues, lawmakers "ought to be worried about the stability of the American political system."


The First Annual Report
of the
United States of America
1994
AN ACCOUNT TO AMERICAN CITIZENS
OF WHERE WE STAND
ECONOMICALLY, SOCIALLY
AND INTERNATIONALLY
MEREDITH E. BAGBY


Where Your Tax Dollar Goes...
Veterans' Benefits 3¢
Other (such as transportation, research and housing credits) 4¢
Education 3¢
Social Security 22¢
Defense 19¢
$1
Medicare 10¢
Welfare 14¢
Interest on Debt 14¢
Health 8¢
Agriculture & Resources 3¢

About the Author and Publisher

Meredith E. Bagby *is a senior at Harvard University in Cambridge, Mass. She is an economics concentrator. She is a member of the Harvard Parliamentary Debate Society and the winner of a Ford Foundation grant to study immigration in Palm Beach County, Fla., where she makes her family home.*

At Harvard Bagby won an Army ROTC scholarship and served in the Army ROTC Harvard/ MIT unit. She is also a Coca-Cola Scholar.

After graduation in 1995, Bagby hopes to attend law school and specialize in a program of law and economics.

Later she plans to work in business and in economic and legal policy for nations in the Americas.

She works part time in research at the National Bureau of Economic Research, Cambridge. She is also employed at the Bradley Real Estate Trust and did business reasearch at JP Morgan.

Bagby has also been a legal assistant at the State's Attorney's office and at Florida Rural Legal Services, both in Palm Beach County.

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Taking Responsibility

A Letter to the American People

"Since World War II we have gone from the world's largest creditor nation to the world's largest debtor nation."

"....never in the history of the world has a debtor nation been able to maintain its power."

All of us have moments that change our lives. That moment came for me as I was sitting in a classroom finishing my second year at Harvard. An economics concentrator, I was attending a macroeconomics class taught by Professor Benjamin Friedman.

For many, economics can be a very dry subject and one which does not touch our emotions. However, something that my professor said that day pounded my emotions. In closing he said, "America is undergoing one of the most critical periods in its history. Since World War II we have gone from the world's largest creditor nation to the world's largest debtor nation.

"We have run a debt which currently equals 80% of our Gross Domestic Product. We are faced with sky-rocketing deficits that do not appear to be coming down. In short, if we continue along the path that we are now there is the great possibility of bankruptcy."

He went on, "It is true that America is the only hegomonic power in the world now. We have defeated, if you will, the USSR in the cold war. We are the only nation capable of defending democracy, capable of launching any substantial war, the only nation with a strong military, a strong infrastructure. But," he added words of warning, "never in the history of the world has a debtor nation been able to maintain its power." These are the words that led me to produce this report.

As a child, as a teenager and as a college student, I was always taught to believe that America was the best nation to live in, that we were the nation with the greatest opportunity and the highest economic prosperity for all and that in the global context America held the world's hope for freedom. As an adult, I see the status that America once gripped rapidly diminishing. One has only to

look at the example of Rome or the Imperial Empire of Great Britain or the once Ottoman Empire of the East to realize that all great nations and all great empires come to an end if they cannot diagnose and cure themselves from within.

I feel a great urgency to try to reverse that seemingly inevitable end. I ask you to join me in taking responsibility to change the course of America.

The symptoms of this ailing society are stark. We spend more than we create. We have unbelievable amounts of debt. We have an ever growing bureaucracy which takes decisions, money and power out of the hands of citizens. But, worst of all, we, the American people, feel helpless. From our low voter registration to our inability to produce and elect leaders of capability, to our high numbers of drug abusers and teenage suicide, to a swelling of crime and urban decay, to our utter disbelief and distrust of our politicians, it is apparent that we have lost our way.

The people who led this nation in its infancy and who conceptualized what America could be knew that an informed population is the keystone of a democracy. Today we are bombarded with more media than they could have ever imagined, but the quality of information coming at us is generally superficial, biased to the right or left or sheer entertainment. We as a population seem to thrive on the frivolous and are not committed to understanding anything beyond sitcoms.

Yet we are outraged when interest rates soar, taking away our chances for a new car, house or better living. If we understand why the economy betrays our wishes, we can then correct the forces that shape our daily life.

You are a shareholder in America because it is your taxes that pay for all federal programs -- from highways to military weapons. In any corporation stockholders receive an annual report to show them what has happened to their investment. We have never seen such a report directed to us as stockholders of this nation.

"From our low voter registration to our inability to produce and elect leaders of capability ... to a swelling of crime and urban decay ... it is apparent that we have lost our way."

"The people who led this nation in its infancy ... knew that an informed population is the keystone of a democracy."

"I urge you to use these facts and figures to question your government, interact with it and make America safe, healthy and vibrant again."

"America stands at the most painful threshold of its life in a world that is being born anew politically and geographically."

This is why I offer you *The First Annual Report of the United States of America 1994.*

Through this report I hope to help you enter or re-enter the political process. For too long we have allowed our nation to run on bureaucratic pilot. We have not been conscientious voters and, indeed, many of us have not voted at all. The only way to have a true democracy, as Thomas Jefferson said, is to be active in it and be educated. We must learn about our nation through individual initiative. This annual report seeks to inform you generally about our economic position so that you will hold our leaders accountable for the future they are creating for us. This report is not partisan in any way. It is merely a presentation of the facts as I have found them.

I urge you to use these facts and figures to question your government, interact with it and make America safe, healthy and vibrant again.

The people of my generation and of the generations before and after me do not want to live in a fallen America. I believe that America is the most fair, the most inspiring nation on earth. I do not want to live in an America that is any less.

America is still the country people literally die at sea yearning to reach. And yet, America stands at the most painful threshold of its life in a world that is being born anew politically and geographically. We are all at a sweeping, brilliant edge of peace and wealth and equality.

At the forefront of this new paradise for the mind and spirit sits America, now deep in self-doubt but still possessing the most poignant promise of hope and freedom in human history. Historians have reminded us that every nation gets the kind of government it deserves. The kind of government that we get is up to each of us.

The American genesis is now and it is the fire and the light of the world. Let us

not be lost for a moment in the short dark of our night of despair.

The freedom envisioned by our founders is now about to begin for the world and we as its designers must be able to prove that our ideals will work.

Our genesis is as vast as the imagination, and it is fair to say with certainty that its main current will be the freedom that is our foundation. Individuals will surely rise to wherever their ability and vision will carry them. No one will be held back by stereotypical molds of the past. We will see technology of such colossal dimensions that geographical boundaries will fall; hunger will be eliminated; goverments will truly reflect the desires of citizens.

Those at today's margins of society will lay down their arms as they are educated and embraced by reachable economic prospects. And their lashing out with hate and crime will cease in direct proportion to their accomplishments through work, which will yield pride and self-belief.

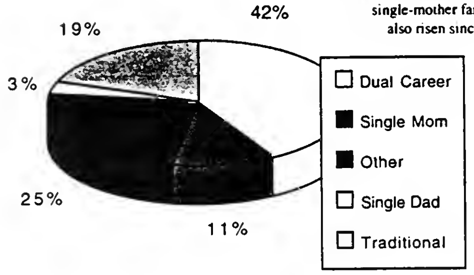
The family, no matter how structured or how diverse, will nurture our young again. And the pursuit of solid values of human worth as opposed to material worship will prevail. Optimism out of today's ashes? Yes. If we can walk out of the quagmires of right now and see the horizon, which is not far away, we will experience an America and a world so magnificent that we will hardly believe its reality.

Meredith E. Bagby

"Optimism out of today's ashes? Yes."

Family Types

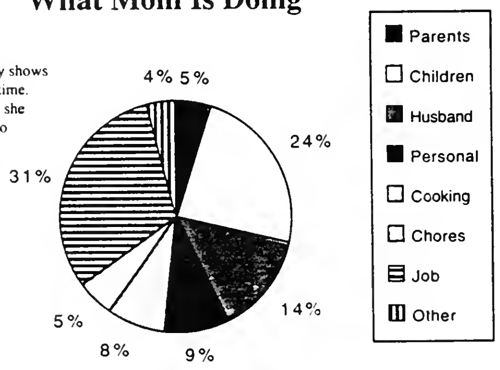
The traditional family, a working father with a mother who stays home, is on the decline. Most families are now dual career. The number of single-mother families has also risen since the 1950s.



The United States of America is a nation of 260 million in a world of 5.7 billion people. We are a diverse nation of people coming from every nation and every race that exists. Though from different backgrounds, we are unified by a common work ethic, a belief in human freedom and a mutual desire to make life better for all of us. We consist of 50 states and the District of Columbia, American Samoa, Baker Island and Jarvis Island, Guam, Howland Island, Johnston Island and Sand Island, Kingman Reef, Midway Island, Northern Mariana Islands, Palmyra Island, Puerto Rico, Trust Territory of the Pacific Islands, Virgin Islands of the U. S. and Wake Island.

What Mom Is Doing

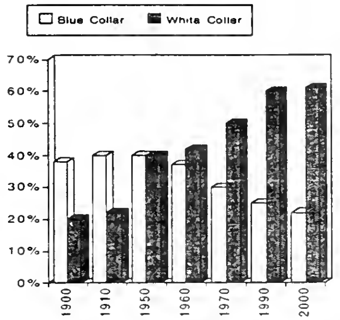
This graph of a typical day shows how a mother spends her time. Since Mom went to work, she has less time to cook, to do chores and to spend with her husband and children than her mother did. She does, however, spend more time at work and on personal matters than did her mother's generation .



Who We Are

Statistics About America...

Percent of the Work Force

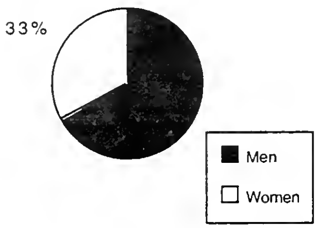


As time moves on, the American work force depends more and more on white collar jobs. The well-paying blue collar jobs which accounted for America's increased living standards for so long have been and continue to be on the downfall while white collar jobs are on the rise.

The Labor Force

1960

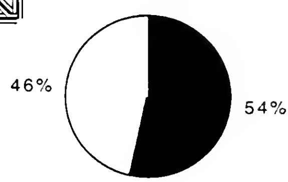
Total= 66 million



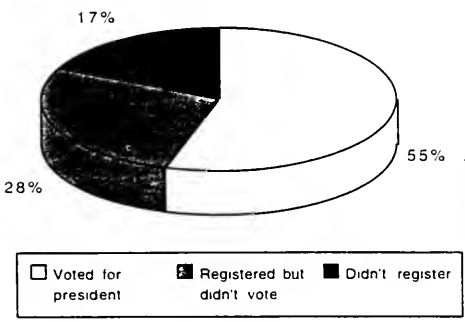
The biggest change in the makeup of the labor force in the past 30 years is the entrance of women. Today women make up almost half of the labor force.

1990

Total = 117 million



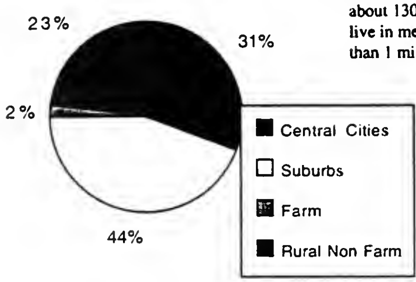
Voters and Nonvoters for President in 1992



Just over half of eligible voters participated in the last presidential election. While this is a low turnout, the percentage is up from the last three presidential elections and higher than the turnouts for Congressional or state elections.

Where America Lives

1992



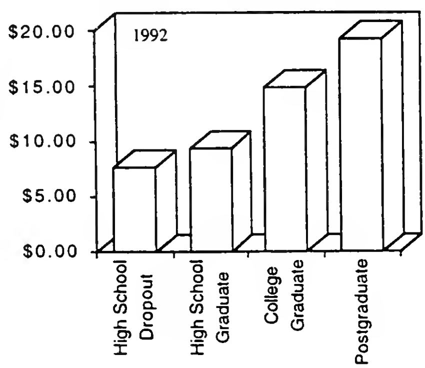
More Americans are moving to the city. More than half our people, about 130 million Americans, live in metropolitian areas of more than 1 million.

Median Family Income

$35,939

1992

Average Earnings per Hour



Education is becomimg a more important determinant of future salaries. As demand rises for educated and skilled workers, the price paid to those with high education rises and the price paid to lesser educated workers falls.

Who We Are

The United States Budget

Net Income: The money that the government collects.
Most of this money comes from taxes of which there are many kinds.

(millions of dollars)

	(actual) 1993	(estimates) 1994	1995
Individual Income Taxes	$509,680	$549,901	$595,048
Corporation Income Taxes	$117,520	$130,719	$140,437
Excise Taxes	$48,057	$54,550	$71,888
Social Insurance Taxes	$428,300	$461,923	$490,393
Custom Duties	$18,802	$19,198	$20,856
Estate and Gift Taxes	$12,577	$12,749	$13,885
NET INCOME	$1,153,535	$1,249,071	$1,353,815

Individual Income Tax
A tax levied on your salary and any other profit you make, for instance, in the stock market or from your savings account.

Corporate Income Tax.
A tax levied on corporate profits. What McDonald's has to pay.

Excise Taxes
A tax levied on certain commodities like tobacco or alcohol. Excise taxes tend to be popular politically. For instance, many suggest that we tax cigarettes so that we encourage people to smoke less. We also put excise taxes on oil so that people will consume less gas.

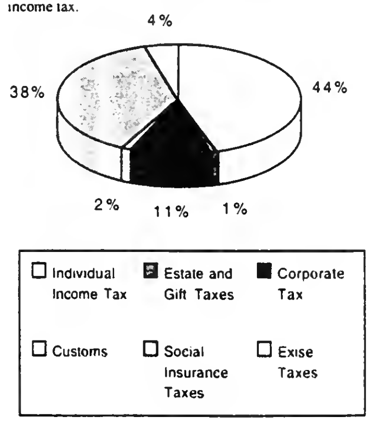
Social Insurance Tax
A tax taken out of wages before the salary ever reaches the individual. The money then put in a fund goes to pay for the Social Security benefits of the elderly retired and disabled. The tax exists to ensure that people will have something to live on once they become too old to work. It is a kind of forced savings.

Estate and Gift Taxes
Estate taxes are put on personal property at the time of death. Gift taxes are levied on large gifts given from one person to another.

Customs Duties
Taxes put on food and goods coming into the U.S. For instance, the tax on Japanese cars.

Where Taxes Come From

Most taxes come from individual income taxes followed by Social Security tax and corporate income tax.



Net Expenses: Anything that the government spends. It includes everything from the cost of building roads to the president's salary to grants to research and development. The government spends our money in essentially two ways: transfer payments and service payments.

(millions of dollars)

	(actual) 1993	(estimates) 1994	1995
Service Payments			
International Affairs	$16,826	$18,968	$17,798
Judiciary	$14,955	$16,479	$17,331
Science/Technology	$17,030	$17,279	$16,941
Transportation	$35,004	$37,582	$38,368
Natural Resources	$20,239	$22,285	$21,817
Defense	$291,086	$279,824	$270,725
Education	$50,012	$50,793	$53,524
Energy	$4,319	$4,988	$4,564
Health	$99,415	$112,252	$123,077
Community Development	$9,051	$9,282	$9,154
Transfer Payments			
Social Security	$304,585	$320,460	$337,168
Housing Credit	-$22,725	-$504	-$5,482
Medicare	$130,552	$143,651	$156,228
Income Security	$207,257	$214,626	$221,440
Veterans' Benefits	$35,720	$38,129	$39,247
Interest on the Public Debt	$198,811	$203,448	$212,835
Net Expenses	$1,408,205	$1,483,829	$1,518,945
DEFICIT	$254,670	$234,758	$165,130

Financial Highlights

Transfer Payments

Transfer payments occur when the government transfers money from one group in society to another, for example when the government taxes the general public in order to give money to the poor in the form of welfare or when the government gives money to the elderly in the form of Social Security.

Some other transfer payments are the Commerce and Housing Credit which gives money to people who cannot provide housing for themselves. Another example is Medicare which provides health care for the elderly.

Service Payments

Service payments occur when the government buys a particular service for the U.S. Examples include building roads, providing for our national defense or investing in science by financing a space shuttle.

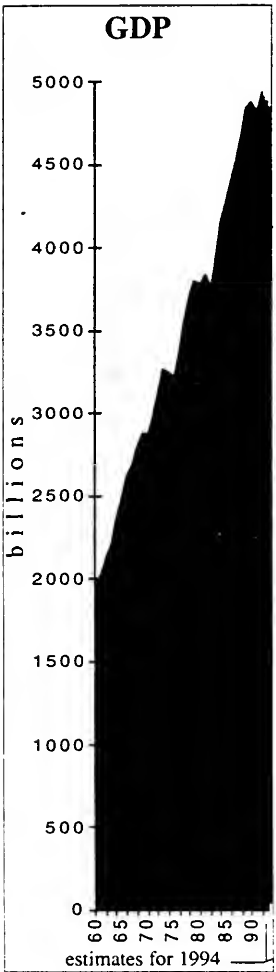
Net Interest

Net interest is the amount we pay each year on our debt. In simple terms, it is this amount that the goverment has to pay for taking out loans.

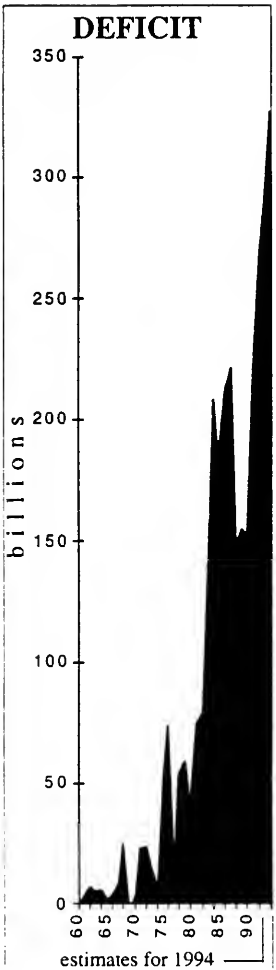
Goverment pays interest by meeting its obligations on U.S. bonds or bills sold to investors. Each year that amount gets larger because each year the U.S. accumulates more debt.

Deficit

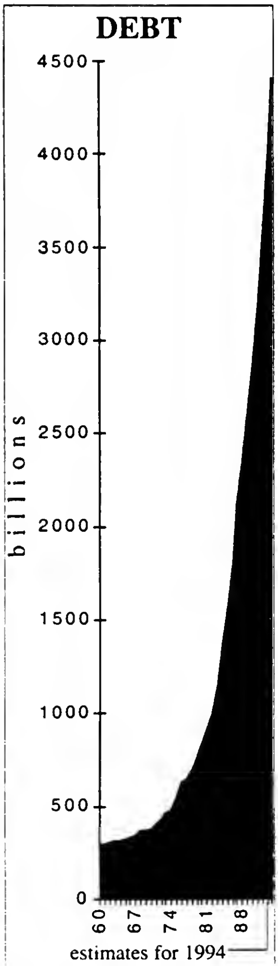
This is income minus expenses or the amount the federal government takes in from taxes subracting the amount that the federal goverment spends. For the last 25 years this number has been negative. The new budget bill passed in 1993 seeks to reduce the deficit by 1998 by cutting spending and increasing taxes.



GROSS DOMESTIC PRODUCT
The graph shows the GDP or gross domestic product. GDP has risen consistently from 1960 to 1993. However, in the past few years -- 1990, 1991, 1992 and 1993 -- that growth has slowed and has even been negative from 1990 - 1991 when America was in a recession.



FEDERAL GOVERMENT DEFICIT
The U.S. deficit has increased most noticeably from 1980 onward. On the vertical axis you will see that in 1993 our deficit was about $260 billion dollars.



FEDERAL GOVERMENT DEBT
The debt in this chart shows that the federal government owes almost as much money as our entire nation produces each year. For the U.S. this enormous debt is a modern problem and the foremost and primary concern for our economic stability.

An Overview of Our Problems...

America seems to be facing one of its most difficult economic periods in its history. Although America still has a better quality of life than nearly any nation on earth, we have deep fiscal problems which may soon undermine our economic well-being and our ability to maintain world leadership for democracy.

While U.S. workers and firms remains the world's most productive, **our productivity growth has been sluggish for almost two decades**. As a direct result, wages and family incomes have advanced extremely slowly — possibly making Generation X, the people presently in their twenties and teens, the first generation in America to have a lower standard of life than their parents.

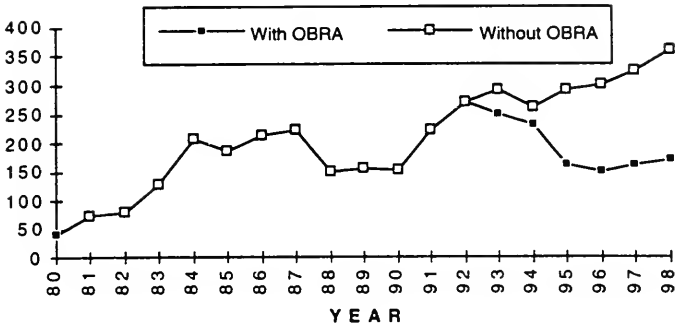
In addition, it seems that the rich are getting richer and the poor are becoming poorer. We have a shrinking middle class as **families get pulled to the fringes of either poverty or wealth.** The National Council of Economic Advisors reports that over the last decade many middle-class and low-income families have actually experienced declines in their real incomes.

Furthermore, the federal budget deficit has been growing and the **national debt has outpaced our growth** rate for nearly a decade. Our extensive foriegn borrowing to finance this debt has transformed the U.S. from the largest creditor nation in the world to the biggest debtor.

IMPORTANT TERMS DEFINED
GDP - stands for gross domestic product and it is the sum of all of the production of goods and services in America for a particular year. GDP is important because it is a measure of how productive we are as a nation. Furthermore, by comparing GDP from year to year we can examine the rates at which we are improving our production.
Deficit - tells us how much the U.S. goverment spends beyond what it makes in taxes. The U.S. has been consistently running a deficit since 1960.
Debt - is money the government borrows, usually to finance the accumulation of the deficit. Debt is the amount that the government owes either to its people or to foreign countries and institutions that invest in U.S. treasuries and other securities. Presently the U.S. is the world's largest debtor. Each year the U.S. has to pay interest on this debt just as you or I do when we borrow from a bank. The interest payment on the national debt in 1991 was larger than the entire gross national product of Mexico.

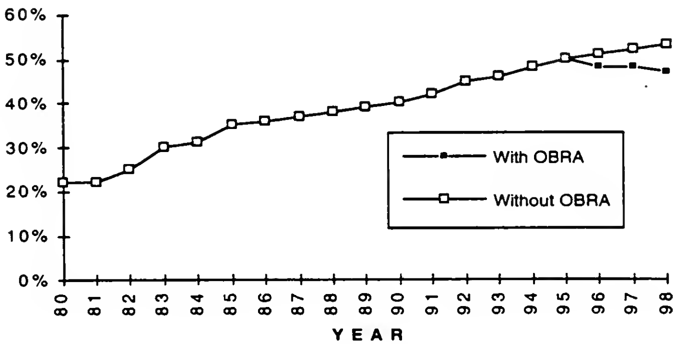
Financial Highlights

Deficit in Billions of Dollars



The deficit will decrease with the implemenation of the president's new budget bill but will not disappear. Even with Omnibus Budget Reconciliation Act of 1993 (OBRA 93), the deficit may resume its upward trend after 1997.

Debt as a Percentage of GDP



As the graph shows, OBRA 93 will put only a small dent in our debt problem. Regardless of the spending cuts and tax hikes, our debt will still remain well above 40% of our gross domestic product and we will likely still remain the world's biggest debtor nation.

Omnibus Budget Reconciliation Act of 1993 (OBRA 93)

After his first few weeks in office, President William Clinton proposed a budget plan to a joint session of Congress. OBRA 93, as it is called, was aimed at reducing the U.S. deficit. According to the plan, the deficit will be reduced by $146 billion by 1998. This reduction consists of $87 billion in net spending cuts and $59 billion in added revenue from taxes.

The government "reduced" spending by putting caps on every aspect of the budget: The government will not increase spending on any portion of the budget. The largest cuts were felt in Medicare (about $18 billion by 1998). Furthermore, the Congress increased taxes on the richest 6.5% of the population.

The OBRA 93 Balance Sheet
(in billions)

	$87 reduced spending
+	$59 new taxes
	$146 reduced in deficit

While OBRA 93 will certainly help reduce the deficit, as we can see by the graph opposite, it will not eliminate the deficit but merely hold it at bay. Even with the reforms, the deficit will still be over 150 billion dollars a year. As we can also see by the graph charting debt, the reforms do nothing to decrease debt. Debt continues to increase throughout the rest of the decade.

All of these projections are offered by the administration itself and are thus relatively optimistic. The situation might even be worse. Many argue that the president will not be able to realize so much new tax revenue as he expects if the rich are able to to hide their money and, thus, avoid paying higher taxes. All in all, OBRA 93 makes only a small dent in a trillion-dollar problem.

How the New Taxes Affect You...

• ***High brackets for top earners*** — a new tax bracket of 36 % applies to taxable income exceeding the following amounts and is retroactive to January 1993.

Single	$115,000
Head of household	$127,500
Couple filing jointly	$140,000
Married,filing separately	$70,000

• ***10 % surtax*** — applies to certain high-income taxpayers. It is computed by applying a 39.6% rate to taxable income in excess of $250,000 for individuals or $125,000 for married couples filing separately.

• ***Limits*** — are put on itemized tax deductions and there is a phase-out of personal exemptions for high earners.

• ***No Medicare tax limit*** — beginning January 1994, you pay a 1.45% on Medicare tax on your first $135,000 of salary and on all earned income. Self-employed people will pay 2.9% to compensate for the lack of an employer's contribution.

• ***Taxes on Social Security income*** — hit harder. Once a retired couple's income tops $44,000 ($34,000 for individuals), up to 85% of their Social Security benefits will be taxed.

For more information see Financial Review.

Financial Highlights

Taking America's Pulse...

VITAL SIGNS

	1992	1993	1994	1995	1996	1997	1998
	Percent change, fourth quarter to fourth quarter						
Real Gross Domestic Product	2.6	2.9	3.1	3.0	2.9	2.8	2.7
Consumer Price Index	2.9	2.8	2.9	3.0	3.0	3.0	3.0
	Calendar year average						
Unemployment Rate	7.4	6.9	6.2	5.7	5.4	5.3	5.3
Interest Rate 91-day Treasury Bills	3.4	3.5	4.2	4.4	4.4	4.4	4.4
Interest rate 10-year Treasury Notes	7.0	6.4	6.1	6.0	6.0	6.0	6.0

The Bad News

The recovery from the recession of 1990 and 1991 has been the slowest and most difficult recovery for America in its post-war history. Growth remained slow, unemployment remained high and consumer demand low throughout 1992 and most of 1993. This slow recovery can be attributed to several different factors.

First, unemployment remained high. America drastically cut back on defense spending thus sending thousands into long-term unemployment. In addition, American corporations began downsizing and restructuring. With rapid technology and corporate restructuring on the rise, many found that their jobs no longer existed. This sent many in search of new training and different kinds of jobs.

Second, growth is slow. It was and still remains difficult for business to find the money to begin new ventures. One reason is that overly tight regulations on banks because of a backlash from the savings and loan crisis has made it hard to borrow money. Furthermore, the U.S. goverment, in order to finance its large debt, is sucking up a lot of available American and international investment funds that would otherwise go to private business.

Finally, America, in comparison to the fastest growing industrialized economies, has invested little over the past two decades in infrastructure, research, technology and education.

As economists tell us, these are the main components of economic growth. It is not surprising that our growth rate, as reflected by change in GDP, is lower than that of Japan, Germany and Korea.

The Good News

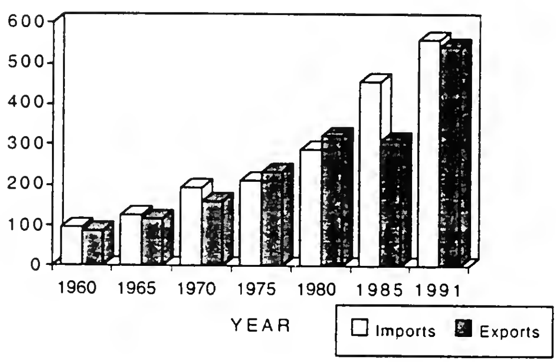
The good news is that although our growth rate has not shown improvement, there is evidence that unemployment is on its way down. The administration projects that by 1997 unemployment will be down to 5.3%. (That is 5.3% of the labor force will be unemployed and looking for work.) According to many economists, this rate is close to the full-employment level -- that is, those who honestly look for work will likely be able to find work in no longer than a few months.

More good news is that the U.S. is experiencing low inflation rates and low interest rates. Both are good for business.

At low interest rates, both businesses and families are able to borrow money more cheaply to begin new ventures --such as buying a new home or builiding a new warehouse. Low inflation engenders confidence about the economy and preserves the value of our assets.

Finally, as the U.S. dollar drops in value in comparison to fonegn currencies, U.S. exports have it better. It is now relatively cheaper for foreigners to buy American and the gap between the amount we import and the amount we export seems to be closing.

U.S. Trade in Billions of Dollars



Throughout the 1980s exports fell short of imports-- we bought more foreign goods than we sold. This was because the strong dollar made imports relatively cheap for the U.S. and made U.S. imports relatively expensive abroad. It is also important to recognize that U.S. trade has increased substantially since 1960 now making up more than 30 percent of our entire economy.

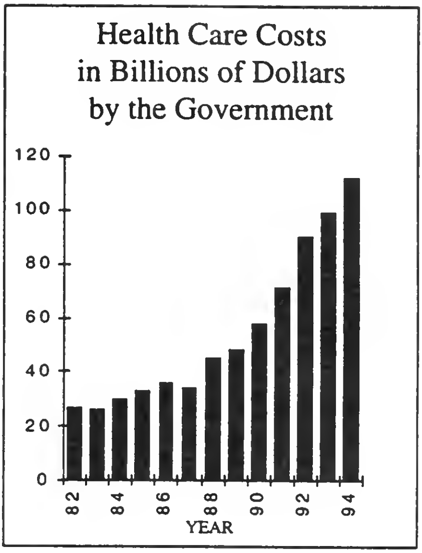
Financial Highlights

HEALTH CARE

Americans are living longer, healthier lives than ever before. Since 1960 the average life expectancy has increased by more than 5 years. Furthermore, America leads the world in medical research and the quality of medical care. American physicians have access to the best medical technology in the world and more than one-half of the world's medical research is funded by sources in America.

At the same time, AIDS claimed the lives of more than 160,000 Americans last year. Tuberculosis, a disease that had almost disappeared in the United States, has re-emerged. Cancer, heart disease and strokes are the leading causes of death in the United States, together accounting for about two-thirds of all fatalities.

But the biggest problems in health care are (1) that health care costs are soaring much faster than the general inflation rate and (2) there are 35 million Americans who are not insured and even more who do not receive proper medical care.



Soaring Costs

The share of the nation's income devoted to health care has been growing rapidly. The United States spends far more per capita on health care than does any other country on earth. One dollar out of every seven dollars spent goes toward health care. The increases reflect higher prices for medical services and the greater use of more sophisticated treatments and services.

The system of health insurance, third-party payment and the lack of incentives to use health services wisely are only a few of the factors that are driving up health care costs. As health care now consumes roughly 25% of the gross domestic product and yet still provides little or no care to many Americans, there is a need for reform.

Health Insurance

According to 1991 Census Bureau data, there are approximately 35 million Americans without health insurance. This means that one out of every seven or eight Americans is not covered by health insurance. The majority of the uninsured seems to be young adults and children of uninsured adults. The uninsured receive insufficient preventative care and often end up flooding emergency rooms.

Most Americans are insured through their employers. Employer-provided insurance benefits have increased dramatically since WW II. A recent survey found that more than 25% of American households included a family member who stayed in a job because of health coverage restrictions. Many employees now pay for increases in health care costs mainly through lower wages. Many of the uninsured workers employed by small firms earn wages which, if the wages were reduced by the cost of health insurance, would fall below minimum wage.

Reform

In campaign speeches, President Clinton promised the American people a complete health care reform package. This package would include universal coverage, employer mandates, price controls on health care and nondiscrimina-

tion rules for insurance companies. Many, even in the president's Democratic party, believe that the president's plan creates too much bureaucracy and puts too many restrictions on individual choice.

Since the president presented his plan to Congress, more than 70 new plans have been proposed ranging from a market-based approach to a completely government-run health insurance program.

Future Legislation

One can only guess what health care reform will look like in the future. However, it seems that the main aims of health reform are:

(1) to reduce the cost of medical care by increasing efficiency. Probably people will be encouraged to see primary care physicians rather than more expensive specialists. There will be an emphasis on preventative care to avoid expensive emergency room visits.

(2) to extend coverage to as many Americans as possible. This will likely be accomplished with some type of entitlement program whereby the poor will be given money to pay for their medical bills. In addition, the government will likely force insurance companies to insure higher risk candidates, i.e., people who have pre-existing conditions.

ABORTION

It is uncertain whether any health care package will contain medical service for abortion. Pro-choice activists argue that abortion should be included, contending that exclusion would discriminate against poorer women and limit their freedom of choice. Pro-life activists argue that including abortion in a health care package would warrant state-subsidized abortion.

There have been approximately 1.6 million abortions per year since 1989. According to a 1992 report by the Centers for Disease Control, women who obtained abortions were predominantly 24 years of age or younger, white and unmarried, yet a disproportionate number of black women also receive abortions.

AIDS

The Centers for Disease Control states that from 1981 - 1992 the reported cases of AIDS were 244,939 in the U.S. In 1994 CDC estimates 1 million people are infected in the U.S. with HIV.

The U.S. Public Health Service reported July 22, 1993, that the lifetime medical cost for an AIDS patient averaged $102,000. In the U.S., the death rate for the human immunodeficiency virus infection rose to 11.3 people per 100,000 in 1991 from 9.5 in 1990.

AIDS is in a tie for 6th place among the leading causes of premature death and among these it is the fastest growing, according to the Centers for Disease Control.

Worldwide, women are becoming infected with AIDS about as often as men.

By the year 2000 most new cases will be women. The World Health Organization estimates that more than 25 million AIDS cases have occurred to 1994.

AIDS COUNT
1994

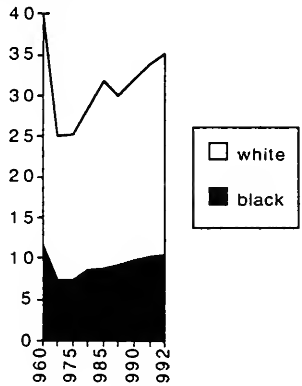
1 million
infected with HIV
in U.S.

POVERTY AND WELFARE

For several decades, the rate of economic growth greatly reduced the poverty rate, but a combination of demographic, social, economic and policy factors has led to an increase in those falling below the poverty line. The national poverty rate of 14.2% in 1991 remains well above the levels reached in any year from 1969 through 1980.

The number of women and children below the poverty line has increased, in part because of the increase in single-mother households. Single-

Millions of People Below the Poverty line



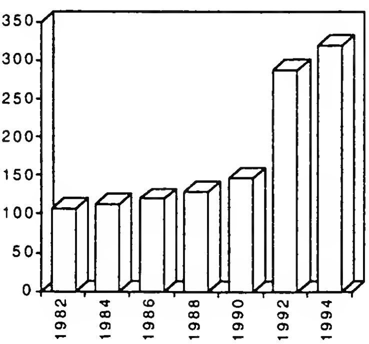
mother households have a greater chance of slipping into poverty than the traditional family or the single-father family. Nationwide, children living in poverty increased 22% in the 1980s. Children remain over represented among the poor, with a poverty rate of 21.8%.

The government offers a variety of programs for those living in poverty including welfare, food stamps and aid to families with dependent children (AFDC). Such programs cost taxpayers billions, and many argue these programs remain ineffective.

Furthermore, many say that these programs send the wrong message. Because remaining on welfare is often more profitable than working and because families are given money based on how many children they have, the welfare system has created a dangerous cycle of dependence.

The desire to reform the welfare system has long been an objective of government. President Clinton's administration is no different. The president has suggested work-fare to replace welfare. The plan would limit the time a person could collect unemployment to two years and would force those people on welfare to work at government-funded jobs in order to receive assistance.

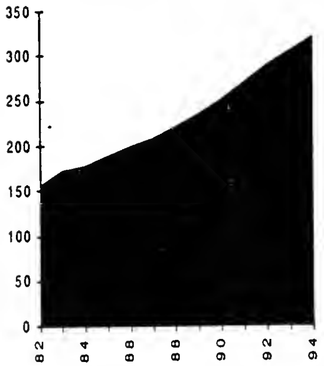
Cost of Welfare in Billions of Dollars



SOCIAL SECURITY

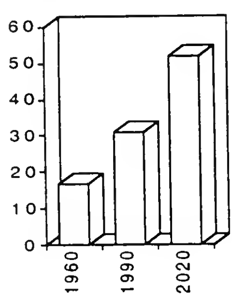
Signed into law by Franklin Roosevelt in 1935, the Social Security Program was created to ensure that the elderly would always have enough money to live on. Since that time, Social Security has become one of the most comprehensive and expensive social programs in the industrialized world. Workers and their employers each contribute an equal amount to the Social Security Program to pay for retirement, disability and Medicare benefits. Presently, Social Security deducts about 8% of earnings.

Cost of Social Security in Billions of Dollars



The problem with Social Security is that we have a growing number of elderly and a shrinking number of younger workers to pay for the benefits to the old. Since 1960, the number of people 65 and over has increased 89% in comparison with a 39% growth for the total population. The age group, 85 and over, has grown at a tremendous 232%.

Millions of People Over 65 in the U.S.



With the Baby Boomers, those born after WWII to 1964, reaching old age in the next few decades, the Social Security system faces serious problems. By the time the Baby Boomers reach retirement, there will be one worker for every three senior citizens collecting Social Security.

The government has foreseen some of these problems and has created a Social Security savings account to cover the future claims of the Baby Boomers, but the fund will likely not be enough and Social Security will continue to be America's most draining social program. Major reform is needed in Social Security, but because the elderly represent such a large percentage of the voting electorate, the system is politically untouchable.

CRIME

The United States is the most violent democracy in the world. Crime, drugs, joblessness and welfare dependency are sapping the strength of America's inner cities. Cities are struggling with crime, inadequate budgets and a disintegrating family structure.

Since 1983 the number of rapes has increased by 38%, robberies by 32%, murder by 23% and violent crimes by a staggering 54%.

Almost 66% of all murders in the United States are comitted with guns. Handguns alone account for more than half the murders. About 80% of all teenage homicides are the result of a firearm injury.

The number of Americans in jail or prison has doubled in the last eight years and has increased about 150% in the last eleven. For every 20 people in the U.S., there is one arrest.

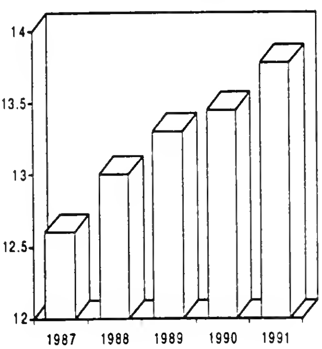
In fiscal year 1991, the U.S. spent more than $20.1 billion on penal corrections including operations and construction, up 20% from the previous year. Still, the prisons are over-

Social State of the Nation

crowded, operating at 52% over capacity.

In 1994, after much debate, the U.S. Congress passed a crime bill which will increase funding to hire more policemen, put a ban on certain assault weapons, tighten the parole system and give money to social programs aimed at reducing crime — these include sports and educational programs. The bill was not supported by the majority of Republicans in Congress basically because of the assualt weapons ban and the costs of social programs.

Number of Serious Crimes in Millions



Child Abuse

In recent years, experts have declared that child abuse and neglect were epidemic. Cases of neglect have overflowed our hospitals, foster care homes, social worker case loads and court dockets. About 2.4 million cases of child abuse, child sexual abuse and child neglect are reported to child protective agencies each year. Since 1990, reports of child abuse have quadrupled. Furthermore, it is estimated that nearly two million children under age 18 are affected in some way by the substance abuse of their parents.

Drugs

A study released by the U.S. Department of Health and Human Services in 1990 estimated that drug abuse costs the U.S. $58.3 billion a year. The rate of illicit drug use remains higher for American youth than for the youth of any other industrialized country. Drug use has remained fairly constant over the past four years with slight increases in the use of LSD.

The most used drug is alcohol. A 1988 National Health Interview Survey reported that 15.3 million Americans exhibit symptoms of alcohol abuse or dependence such as binge drinking and loss of control. The economic costs of alcohol abuse were estimated to be $98.6 billion in lost productivity, deaths and treatment programs.

Another popular drug is tobacco. Approximately 400,000 people die each year because of diseases caused by smoking. Among adults, smoking has decreased but smoking among young people has remained fairly constant.

EDUCATION

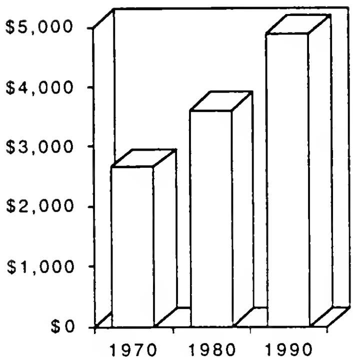
More than 60 million students and approximately 7 million teachers, administrators and support staff are involved in America's public educational system. Expenditures on public elementary and secondary schools have been increasing faster than inflation and now account for 7% of GDP.

Improvements in the skill level of the U.S. labor force over this century have been dramatic. By 1990 the typical worker had completed almost 13 years of schooling and more than one-fifth of all Americans aged 25-29 had completed 4 or more years of college. These increases in education have generated returns in the form of higher wages.

Despite this good news, America still lags behind most of the industrialized countries in high school and elementary education. According to studies, U.S. children fall behind their peers in Japan, Germany, France and Korea in math, science and geography. However, at the college level U.S. students are considered equally and often better educated than their peers in other countries.

In order to reduce costs and improve the quality of our secondary education, many argue that reform is needed. Among the plans for reform are: (1) to increase competition by giving grants to

Per Pupil Spending in America's Public Schools



families to choose a public or private school for their children; (2) to raise standards for becoming a teacher; (3) to eliminate administration and give more power to teachers; (4) to encourage private business to help in training at school.

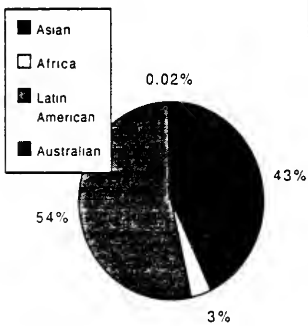
IMMIGRATION

Approximately half a million people immigrate to the U.S. annually and well over half of them are from two ethnic backgrounds — hispanic and asian.

The number entering the United States has increased steadily since the early 1960s — from 1.5 million in 1960-64 to 5.6 million in 1985-90. About 7.9% of the nation's population was foreign born in 1990, the highest proportion in the past four decades.

Under the current system, immigrants can gain protection from the U.S. if they prove that they are fleeing from political persecution. Although the courts are filled with immigration cases, there is evidence that the majority of immigration is

Breakdown of Immigration 1992



now illegal and undocumented.

Over the past several years, immigration has been at the forefront of political debate. Immigrants from China, Haiti, Cuba and Central America flee oppression in their home countries and flock to certain American cities—mainly New York, Los Angeles and Miami.

American voter sentiment is generally anti-immigration. Many argue that immigrants take jobs from U.S. workers and soak up too many government services — from education to medical care. Others argue that the U.S. has an obligation to political refugees and that immigration provides the U.S. with cultural diversity and a stronger workforce.

Social State of the Nation

Reforms are underway in Washington, D.C., and we will likely see major changes in immigration policy in the future.

Top 5 States Admitting Immigrants	
States	Percent
California	34%
New York	14%
Florida	8%
Texas	8%
New Jersey	5%
Illinois	5%

HOMELESSNESS

Both policy experts and the citizenry as a whole seem to be less optimistic than they once were that the homeless problem can be eradicated. In 1987 the Urban Institute made an estimate of 500,000 to 600,000 homeless in America. The U.S. Bureau of the Census found a total of 178,828 persons in emergency shelters for the homeless and 49,793 persons visible at pre-identified street locations during a special count in 1990.

About 25% of all these homeless families are headed by women who left home to escape domestic violence. Another 50% of the homeless are single men. About 20% of the homeless are employed in full or part-time jobs and another 25% are veterans.

Many homeless are drug abusers and an even greater number are mentally ill. Leading causes of homelessness, according to a survey of mayors, are: lack of affordable housing, domestic violence, unemployment, drug abuse and teen pregnancy.

Congress appropriated approximately $1 billion last year to deal with the homeless problem. yet cities and towns continue to pay the majority of the bill. New York City reports that it spends about $500 million each year on services for the homeless.

EVENTS WITH SOCIAL IMPACT

• More Americans won the Nobel Prize than any other nationality. Winners were: **Dr. Joseph H. Taylor** and **Dr. Russel A. Hulse** in the field of physics, who won for discovering the first known binary pulsar; **Ms. Toni Morrison**, author of *The Song of Solomon, Beloved and Jazz*, literature; **Kary B. Mullis**, chemistry, for inventing a method of duplicating DNA; **Robert M. Fogel** and **Douglas C. North**, economics; **Dr. Philip A. Sharp**, for his discovery of split genes.

• Football superstar, **O.J. Simpson**, was charged with the murder of his former wife and her young acquaintance. Aside from being the one of the most interesting legal cases in history, the case also sparked questions of race and brought into light the issue of domestic abuse.

• The Midwest and South suffered the worst **flood** in over 100 years. Congress provided $6.2 billion dollars in flood relief. More than 70,000 were left homeless.

• An **Eastern storm** hit the nation in March of 1993 claiming 200 lives. The storm swept through the East Coast and the Southeastern part of the United States with as much as 36 inches of snow in some areas.

• A terrorist bomb blew up and damaged New York City's **World Trade Center**, killing 6 people.

• Senator **Robert Packwood** was charged with and apologized for behavior in the treatment of women.

• **Robert Rota**, former Postmaster of the U.S., pleaded guilty to conspiring to embezzle public funds. He admitted to giving as much as $30,000 to house members later reported to be Rep. **Dan Rostenkowski**, Democrat of Illinois, and former Rep. **Joe Kolter**. Democrat of Pennsylvania.

RESEARCH AND DEVELOPMENT (R&D)

Under the new budget, civilian Research and Development will get a $1.2 billion boost. In paving the way for the "information highway," the president is requesting $1.2 billion, a 20% increase, for research on building more sophisticated computers for use in weather forecasting and drug design in 1995. The administration is also requesting $1.8 billion for the Global Change Research Program which will coordinate studies of global warming and other envionmental issues.

National Science Foundation

The National Science Foundation will receive $329 million, a 43% increase over last year. The majority of this money will go toward high performance computing and research in communications and global change. The National Institutes of Health will receive an increase of $11.5 billion dollars. This money will go to programs for AIDS and tuberberculosis among others.

NASA

Converesly, National Aeronautics and Space Administration's budget has received some cuts with the deepest in human space flight, building of advanced solid rocket motors for the space shuttle and research into a second-generation launch vehicle to replace the space shuttle. However, NASA did receive an increase in funding for its Mars Surveyor Program.

Department of Commerce

The Department of Commerce's technology administration is scheduled to receive a $438.4 million increase. Most of the increase will go toward the Naional Institute of Standards and Technology. The money will be used for high-risk, high-payoff projects, renovation and basic research.

Spending on Research and Development in Millions of Dollars

Department or Agency	1994	1995	% Change 1994-1995
Defense	$35,538	$36,538	1.00%
National Institutes of Health	$10,845	$11,350	1.70%
NASA	$8,493	$8,597	-1.80%
Energy	$6,054	$6,052	-3.00%
National Science Foundation	$2,026	$2,220	-6.60%
Agriculture	$1,393	$1,394	-2.90%
Commerce	$985	$1,322	31.20%
Transportation	$605	$692	11.40%
Environmental Protection Agency	$533	$571	4.10%
All other	$1,824	$1,726	-8.40%
R&D Facilitices	$2,589	$2,016	-25.00%
R&D Total	$71,073	$73,045	-0.20%

Social State of the Nation

DEBT AND DEFICIT

Understanding the Deficit

In order to understand our economy, we must understand our journey to the present. Much of our present economic situation is a reflection of our political past. The most relevant period of history for us to understand is probably the 1980s. In some ways the 1980s were very good for the U.S. but in other ways they left us with painful legacies.

President Ronald Reagan had a very definite plan for the United States. He believed that we should have minimal government, lower taxes and lower spending. He tried to make these policies a reality.

In his first years in office, President Reagan initiated some of the largest tax cuts that the U.S. has ever known. He cut both corporate income tax and personal income tax. Money which would have gone to taxes went into buying consumer goods, into investing in the stock market, into building new homes.

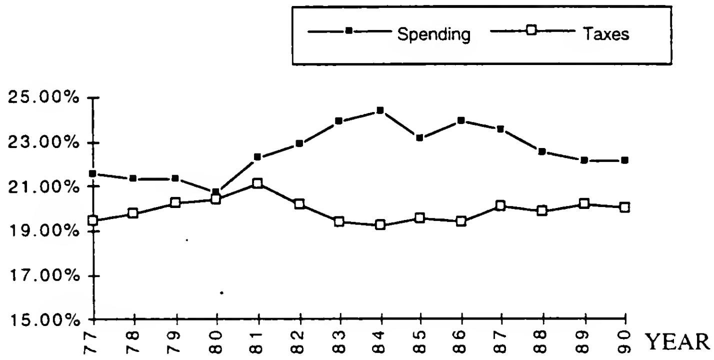
This release of money to the private sector, along with a deregulation of business, made the 1980s the longest period of peacetime growth.

While his tax cuts were passed in Congress, the president's spending cuts were less successful. Attempts to reduce and reform spending on Medicare, welfare and Social Security, among other entitlement programs, could not gain enough political support. The cuts that were implemented were not large enough to cover the reduction in tax revenue.

This situation drove a wedge between America's income and expenses. We began to spend a lot more than we were able to take in from taxes, and, thus, we created the high deficits of the 1980s.

As a result we went from the largest creditor nation of the world to the largest debtor nation.

Federal Spending and Total Taxes as a Percent of GDP



Bankruptcy?

The first and most obvious reason the U.S. doesn't want to have debt is very obvious: bankruptcy. If we kept operating as we are today, the U.S. government would go bankrupt. It is a little hard to imagine what it would be like during a country's bankruptcy.

Bankruptcy would mean a certain amount of government shutdown -- construction in progress would halt; Social Security recipients might stop getting their checks; schools would close; inflation would probably be high. The country might look a lot like pre-WWII Germany or Russia at the end of the cold war.

Low Growth Rate

Living with constant deficits is a dangerous risk for America -- not just because of the possibility of bankruptcy. Economists also believe that our deficits are slowing our growth rate because deficits tend to draw money away from the private sector— where nearly all economic growth occurs.

In order to raise money to finance the deficit, the government must (1)tax its citizens and (2) sell government securities such as Treasury Bills. These two activities divert money from private investment into the government for its spending.

The high interest rates and the security of government bonds entice people to invest in government bonds rather than putting the money in the bank or investing in the stock market.

Because a great amount of our capital is going toward taxes and buying government bonds, there is little money left for private industry to grow and expand.

Since most government spending goes toward entitlement programs, the government does not add to the growth of the economy. The government, therefore, does not create wealth, like the private sector, but rather redistributes that wealth.

DRAWBACKS OF LIVING WITH DEFICITS AND DEBT

- **Higher Interest Rates**
- **Lower Investment**
- **Lower Growth Rate**
- **Lost Revenue to Pay Interest on Debt**
- **Being a Debtor to Foreign Countries**
- **Lower Sales of Exports**
- **Long-term Decrease in the Standard of Living**

Lost Money on Interest

Another drawback in living with debt is the fact that the U.S. has to pay interest on our debt. When the government borrows money it has to pay that money back with interest just as any individual or corporation does. The estimated interest for 1994 on our debt is 204 billion dollars — four times the amount we spend on education. This is money that could be going to

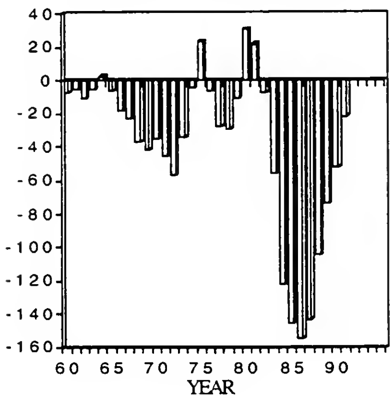
Economic State of the Nation

public schools or to the space program or to AIDS research.

The Trade Deficit

The legacy of foreign debt is not the only cost of our foreign borrowing. To attract foreign investors to America in order to finance our debt, the U.S. had to offer higher interest rates. This in turn led to a high demand for U.S. dollars which resulted in an appreciation of the dollar. The high dollar value made it cheaper for Americans to buy imports but harder for American exporters to sell their now relatively expensive goods abroad. Thus, throughout the 1980s American exports fell and American industry was hurt.

Net Exports
in Billions of Dollars



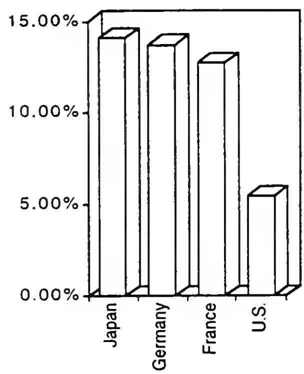
LOW SAVINGS RATE

Another concern of the American economy is the fact that America now has a slower growth rate than many industrialized countries. This means that the U.S. is not moving forward by producing new technology or products so fast as our competitors. Economists have studied this issue for many years and seem to believe that the reason the United States is not growing so rapidly as these other nations, such as Japan, is that America does not save and invest its money in the future.

The U.S. saves roughly 3% of its income. Japan saves nearly 9% of its national income. Economists point to this difference in explaining the fact that Japan has a higher growth rate than the U.S.

The money that is saved in a country — that is, the money that each and every citizen puts into the bank— can be used for investment purposes. For instance, the money in a bank is loaned out to build and finance the purchase of new houses, to start new business ventures and build inventories.

Comparative Savings
Rates

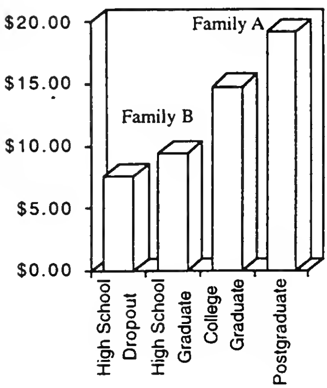


When people don't save, there isn't any money in the bank to lend out. There is no money for the entrepreneur to start his new business and, thus, there is no new growth. This is precisely what is happening in America. We use most of our money for consumption goods —VCRs, televisions, cars, furniture — and not enough for research and education.

If we look to the example of our own families we can see the connection. Suppose we have two families, equal in all relevant aspects. Family A works very hard and puts 10% of its income in a savings account so that its child can go to college.

Family B chooses not to save its money but

Comparative
Per Hour Earnings



instead buys a new car, a television and a VCR, all Japanese.

The child in Family A goes to college but the child in Family B does not have enough money to pay for college. Over the course of a lifetime, Child A will be able to make a lot more money than Child B because he has a college degree. Family A decided to invest in its child's future and, thus, will be richer in the future than Family B.

We know from our own families that when we save, we are able to invest in really important things, such as our children's educations. In this way, we can make great strides in our quality of life. The fact that many Americans have not learned this lesson means that in the future we could have a lower standard of living than the Japanese. The Japanese and the Germans and many other peoples are becoming richer faster because they are saving and investing more. The U.S. is eating all of its dollars now while these countries are saving and preparing for the future.

Economic State of the Nation

GROWING INEQUALITY

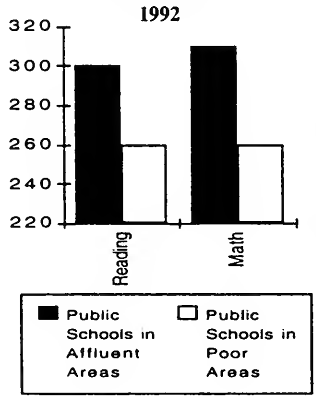
Ever since the 1970s, inequality in income has been on the rise. Presently, we have the widest rich-poor gap since the U.S. Census Bureau began keeping track of these statistics in 1947. The top one-fifth families now earn 44.6% of all income in the U.S. compared to 4.4% of income for the bottom fifth. The national income of the richest 5% of Americans rose from 18.6% in 1977 to 24.5% in 1990 while the share for the poorest Americans fell.

There could be a variety of reasons for this increasing inequality.

(1) A less progressive tax system allowed the rich to keep more of their income and did not redistribute money to the poor.

(2) There is now a greater premium

Average Scores for
12th Graders
1992



put on education. More educated workers became more highly paid while less educated were paid less.

Presently, there is less demand for blue-collar workers than in the past. Import competition and immigration have sent blue-collar jobs abroad. Furthermore, technology has made other blue-collar jobs unnecessary.

Business Week reports in August of 1994, "The well-paying blue-collar jobs that gave U.S. workers rising living standards for most of this century are vanishing. Today you can all but forget about joining the middle class unless you go to college."

Furthermore, most evidence suggests that the majority of college-bound children come from middle to upperclass families. Not suprisingly these children make higher scores on standardized tests. This means that these college-eduated children will likely remain in the upper class while the children of the poor who do not attend college will likely remain poor because of their lack of education.

GROWING GAP BETWEEN THE RICH AND THE POOR

Income Level	Average Family Income as Share of National Income		Average Family Income		% Change
	1980	**1992**	**1980**	**1992**	
Top 25%	48.2%	51.3%	$78,844	$91,368	up 15.9%
Second 25%	26.9%	26.3%	$44,041	$46,471	up 5.5%
Third 25%	17.3%	16.0%	$28,249	$28,434	up 0.7%
Bottom 25%	7.6%	6.5%	$12,359	$11,530	down 6.8%

SLOW RECOVERY

During the past several years, the economy has experienced a slowdown in economic growth beginning in 1989 and reaching a peak with the recession of late 1990 and early 1991. An unusually weak recovery came in March 1991.

During 1992, the U.S. economy remained in a modest and uneven recovery with the rate of growth picking up to the 2.5 to 3% range.

Economists point to several reasons for the slow recovery from the recession. First was the downsizing of the military. The large cuts in defense spending created much unemployment. Second, just as the U.S. was recovering from the recession, Japan, Germany and many other countries were just beginning their recessions. Because the U.S. trades so heavily with these countries, the U.S. export market was hurt.

Finally, the fact that America has such high debt created a credit crunch. Large government deficits that were taking money from the private sector, coupled with overly tight regulation on bank lending — because of the fear of another savings and loan crisis — contributed to the fact that businesses could not find money to expand.

SIGNS OF IMPROVEMENT

Although growth was sluggish in 1993, the economy is now beginning to make some headway. By the latter part of 1993, the economy was said to have grown by about 6% (annual rate). Demand and final sales increased. Furthermore, there seemed to be improvements in labor productivity.

Consumers have trimmed their installment debt and have taken advantage of low interest rates to refinance their mortgages. Low interest rates have helped households and businesses reduce the

cost of paying off existing debt. Low mortgage rates helped to make housing more afford able in the 1990s than it had been at any time in the past 18 years and created a burst of refinancing activity.

Corporations have been raising equity,, on balance, for the first time in several years. America is once again the world's leading exporter and is more internationally competitive than it has been in many years.

LOW INFLATION

During 1992, inflation fell to the lowest rate in a generation. Slow money growth over the past several years contributed to, as well as reflected, the sluggish economy and waning inflationary pressures. Inflation is expected to remain low in the coming years not only because of the excess capacity of resources in the immediate future but also because of the Federal Reserve's ongoing efforts to keep inflation in check.

Low inflation not only benefits the economy but helps set the stage for sustained economic expansion. Low inflation also helps to maintain the purchasing power of Americans' savings and wealth.

UNEMPLOYMENT FALLS

The unemployment rate is the number of people who cannot find work divided by the total labor force. The unemployment rate helps to measure whether the economy is operating at full potential, that is if we are using all our labor.

The unemployment rate, although it was high during the recession of 1990 and 1991, is expected to show steady but gradual decline reaching a level of 5.3% by 1997.

An increase in labor productivity is expected to continue as the economy settles into a sustained expansion and higher investment boosts the stock of productive capital.

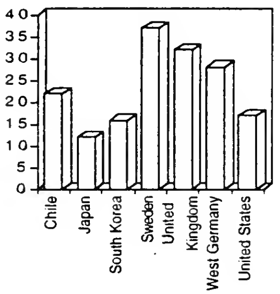
TAXES

President Clinton's new tax bill raised tax rates on the wealthier members of society. He also reduced certain tax deductions in an attempt to reduce the deficit.

The good news is that our tax burden still remains less than that of many countries in Latin America and the European Community, although our tax burden is higher than many Asian countries.

Probably the biggest problem

Compartive Tax Burden as a Percent of GNP



with our tax system is the fact that it distorts taxpayers' choices about how to consume, save and invest. The present income tax misallocates capital across the economy because income earned by different assets is taxed at different rates.

Moreover, the current system taxes interest on savings, dividends and capital gains, creating double taxation. As a result, taxes create a bias against investment, favoring current consumption over future consumption. This is a problem because it encourages people not to save and thus inhibits our growth potential.

AMERICA'S PLACE IN THE NEW WORLD ORDER

Ethnic Wars and Civil Unrest

Ever since the end of the Cold War in the late '80s, America has been struggling to redefine its foreign policy. The old order of the bipolar world which kept ethnic tensions in check for so many years no longer exists. The globe is torn by ethnic wars and civil unrest: Bosnia, Somalia, Rwanda, the Middle East, Haiti and throughout the former Soviet Republics. As 1994 ends, there are more than three dozen trouble spots around the globe — either now in open conflict or ready to fight at the slightest provocation.

Amidst the turmoil, America debates how to react. Should America remain the protector of human rights and freedom for the world? And if we should, what groups should we support in the various civil wars that are raging all over the globe? Should we merely send troops to keep the peace as we did in Somalia? Should we allow our troops to attack as we did in the Gulf War? If we do engage, will the American people be willing to give up not only valuable resources that could be used domestically but also the lives of our soldiers?

A Confusing Foreign Policy

As it stands now, America has no clear foreign policy. It seems that we are reacting to events as they arise in no certain pattern. Most experts agree that this kind of reactionary foreign policy is dangerous.

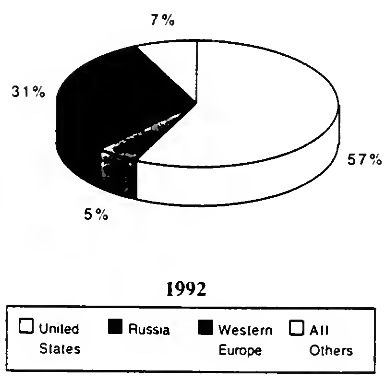
Our actions in Bosnia, Somalia, Haiti and Cuba have been confusing and ineffective. In Bosnia, Serbians continue to target civilian areas and have failed to uphold agreements to honor 'safe-haven zones' or to remove some of their larger weapons. In Somalia, our troops were fired on and were ineffective in bringing any comprehensive help to starving areas.

In the Caribbean in recent months we have also experienced failure. In Haiti, our embargo has failed to oust the military coup leaders. Because our troops were not allowed to fire, our peace-keeping forces could not land on the island as they were fired on by the Haitian military. Finally, in Cuba our long-standing reluctance to recognize Castro has not driven him from office. In an attempt to fight back, Castro seems to be generating another "Mariel Boat Lift" of Cuban exiles into South Florida.

One of the facts that makes taking any strong military action difficult is that these lesser developed nations have access to sophisticated weapons -- mainly because our defense contractors are selling them weapons. While there have been a number of improvements concerning the ban of weapons, trading in weapons is still a very profitable market. Not surprisingly, the U.S. has been the major supplier of arms to the Third World. In 1992, the U.S. accounted for more than half of all arms transfers to the Third World.

In order to deal effectively with the new kind of challenges that appear in our world, most military and foreign policy leaders agree that we need a clear, cohesive plan. As a people, we must demand that our leaders develop a structured and strong foreign policy for the defense of our nation.

Arms Transfers to the Third World



As former Secretary of Defense Casper Weinberger points out, "The only effective way to avoid war is to demonstrate credibly that one is strong enough, resolved enough and prepared enough to go to war." It is foolish to believe that just because the Cold War is over America is safe. Indeed, we may be in greater peril than ever before. Judging from an upsurge in terrorism such as the World Trade Center bombing, the new terrorist training camps in Afghanistan and the sale of nuclear and conventional weaponry by the former Soviet Republics and by America itself, the world sees an America that still has much to battle.

A New Kind of Military

To meet the challenges of the New World Order, America must redirect its military to deal with ethnic and civil wars. Since the end of the Cold War, the U.S. military has tried to transform itself from an entity capable of conducting a complete nuclear war against the communist world to an entity able to launch small, fast, conventional units for peace keeping in distant lands. We must be ready for a variety of different terrains and a variety of different conflicts. In a world where conflict could spring up anywhere, our greatest weakness is not knowing our enemy.

Furthermore, as many military strategists point out, coming wars will be wars of technology. In the future, our enemies may introduce viruses into our computers rather than launching bombs on our shores. They may genetically engineer diseases or intercept our communications with satellites. These are the kinds of attacks that America must be capable of combating.

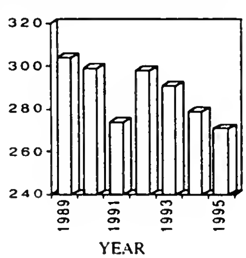
A military projection game played by the Military Academies pits America against China decades into the future. China wins because she is able to muster the technological know-how to win the space-age war. Such futuristic exercises indicate that America's defense program is lacking.

Amidst a need for transformation, the military has had to deal with large budget cuts. By 1997, defense will suffer reductions greater than 40 billion dollars. Furthermore, 130 military bases are scheduled to close and another 45 bases are scheduled for scaling down. The star wars defense plan was abandoned by the defense department in order to reduce the size of the defense budget. Thirty billion dollars had already been spent previously on research.

Weapons Ban

- After 24 years of negotiating with more than 120 countries, the U.S. signed a **chemical weapons ban**. Countries are given 10 years to destroy any existing stockpiles of chemical weapons. The only country refusing to sign the agreement was Iraq.
- The United States and Russia agreed to reduce their strategic **nuclear arms** by two-thirds.
- After some tense moments, North Korea promised to give up its **nuclear weapon production** in exchange for some economic and technological help from the U.S. and South Korea.

Defense Spending in Billions of Dollars



International State of the Nation

INTERNATIONAL TRADE

Trade has become an ever more important sector of the U.S. economy. Presently, the U.S. has a trade deficit. This means that we import more than we export. In other words, we buy more foreign products than foreigners buy American goods. There could be several reasons for this:

(1) Some countries, such as Japan, have high trade barriers making it difficult for the U.S. to sell products there.

(2) The U.S. dollar has been high compared to other currencies making it expensive for foreigners to buy American and inexpensive for Americans to buy foreign.

(3) U.S. products are less competitive than foreign products.

America's Trade Deficit or Surplus with the Rest of the World 1992

Austrialia	5.8 billion
Western Europe	17.1
Canada	-19.8
Japan	-50.5
OPEC	-13.0
Eastern Europe	3.6
Other	35.6

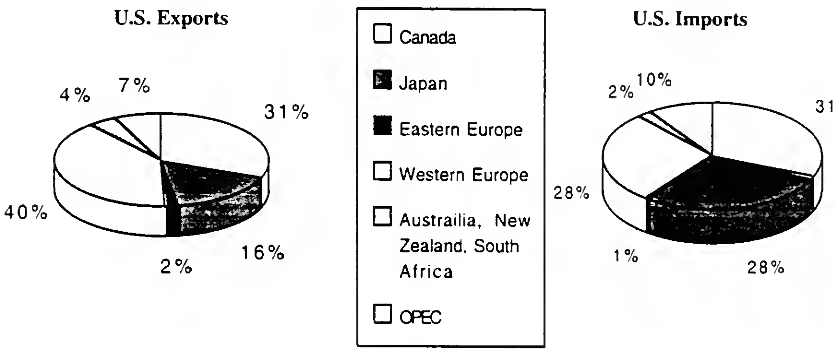
Free Trade

Over the past several decades, the world has become more interdependent economically. Between 1965 and 1990, inflation-adjusted merchandise exports grew by 439%, while world production rose 136%. As trade becomes more important to their economies, nations try to promote free trade by encouraging the peoples they trade with most to lower their tariffs (or taxes on foreign goods). During the past several years, we have seen the development of free trade zones in Europe (EC), North America (NAFTA), South America (Mercosur and the Andean Pact) and Asia (APEC).

Nearly all economists agree that free trade brings great benefits to all. Free trade offers consumers the greatest number of choices at the best prices. The philosophy is that we can all benefit from each other's strengths. If, for instance, the Japanese make better radios and the U.S. makes better refrigerators, then it benefits both countries to trade what they do best. In this way, American citizens can buy great radios and the Japanese can purchase great refrigerators and both countries are better off than if they had not traded.

It is this gradual realization that trade benefits all concerned that has driven America and most other countries to work toward free trade. This is not an easy goal. While free trade benefits

America's Trading Partners
1992



everyone in the long run, it is sometimes difficult for a nation to make the transition to free trade. This is because free trade often forces a nation to restructure its economy.

Going back to our example of the U.S. and the Japanese, we might observe that when the U.S. begins to trade with Japan, the U.S. radio manufacturers are hurt by trade because people buy Japanese radios rather than American. Gradually, U.S. citizens unemployed by the radio industry have to find new jobs — for instance, the new jobs created by the refrigerator industry. While this process of restructuring can be a painful one for society, it yields great benefits by forcing the country to produce more efficiently, making the whole society richer in the long run.

WHAT FREE TRADE WILL YIELD FOR AMERICA

The Uruguay Round of GATT
$100 billion annually from increased exports and cheaper imports by 2005.

NAFTA
200,000 new jobs from increased demand for U.S. exports within 15 years.

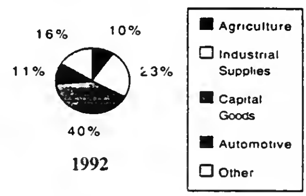
GATT

The General Agreement on Tariffs and Trade (GATT) was established in January 1948 to reduce tariffs and to promote free trade. Eighty-seven signatory countries and an additional 27 countries belong to GATT. Together they account for 85% of all world trade.

The latest set of negotiations in the General Agreement on Tariffs and Trade (GATT), the Uruguay Round, was completed in 1994. The agreement called for the lowering of tariff and non-tariff barriers in a variety of different areas including agriculture. It also attempted to address complicated issues such as intellectual property rights. The agreement is said to add about $300 billion to the world product in increased productivity.

NAFTA

Breakdown of U.S. Exports



By a close vote, the North American Free Trade Agreement was passed by Congress. Over a period of 15 years, NAFTA will eliminate most trade barriers among Canada, Mexico and the U.S., making the three countries a free trade zone. The treaty creates a free trade area of 370 million consumers and more than $6.5 trillion of annual output, linking the U.S. to our largest trading partner, Canada, and third largest trading partner, Mexico.

The main arguments against NAFTA were that (1) Americans would lose their jobs to cheaper foreign labor and (2) environmental standards of Mexico were not up to American or Canadian standards. To correct these problems, NAFTA (1) created funds to support and retrain those who might lose their jobs to Mexican or Canadian workers. In addition, NAFTA is to be implemented slowly giving people time to adjust and (2) NAFTA forced Mexico to comply with stricter environmental standards.

THE ENVIRONMENT

Global Warming and the Depletion of Ozone

Scientists believe that at the current rate the earth is likely to warm by as much as 3° to 5°F over the next 50 years. This warming could set off a chain of events beginning with the melting of the polar ice caps, a rise in the sea level, flooding and the eventual destruction of much coastal land.

Risks According to the Environmental Protection Agency

High Risk	Habitat Destruction Global Warming Ozone Layer Depletion Species Extinction Biological Diversity
Medium Risk	Pesticides Surface Water Pollution Air Pollution
Low Risk	Oil Spills Radioactive Materials Groundwater Pollution

Global warming is occurring because sunlight is trapped inside the earth's atmosphere by toxic gases that emanate from our industries, cars and other man-made products. This is most commonly known as the greenhouse effect.

Greenhouse gases include chlorfluorocarbons (CFCs), methane and nitrous oxide. The worst gases are the CFCs because they also destroy the ozone layer which protects the earth from the sun's ultraviolet rays.

In this decade, delegates from 87 nations met in Copenhagen and together they agreed to increase the schedules for phasing out chemicals that damage the earth's ozone layer. Under the agreement, some chemicals would be regulated for the first time. Chloraphorbins, the chemicals thought to be the most harmful to the ozone, will be phased out by 1996. CFCs have been traditionally used in air-conditioning, cleaning, insulation and as aerosol propellants.

Deforestation and Loss of Biodiversity

The great majority of deforestation today occurs in the tropical rain forests located in Central and South America, equatorial Africa, Southeast Asia and Northeastern Australia. It is estimated that the world may be losing more than 49 million acres of tropical rainforest each year.

With the loss of forest comes the loss of biodiversity. In a four-mile radius, a typical patch of rain forest contains 750 species of trees, 750 species of other plants, 125 species of mammals, 400 species of birds, 100 species of reptiles and 60 species of amphibians. The destruction of all of this life has dire consequences for the human race. For example, of the 3,000 plant species that help fight cancer 70% are located in the rain forest.

Destruction of Wetlands

Wetlands regulate water flows by storing water and buffering the effects of storms, purifying and filtering water and providing a habitat for a wide variety of plants and animals.

Over the past several decades, though, wetlands have been drained, cleared, exploited and built on. It is estimated that America has more than half of its original wetlands. This loss has resulted in the pollution of fresh water, loss of species and erosion of land.

Superfund

In 1980 Congress created the Superfund which provides $1.6 billion for the cleanup of thousands of hazardous waste sights, but there have been many complaints about the Superfund. In its history, it has only cleaned 84 high priority sites and of the $1.3 billion spent thus far, $1 billion has gone toward legal fees.

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Financial Review

"Each year, you work to May 3
just to pay your taxes.
Looking at it another way, you
work 2 hours and 41 minutes
in your eight-hour day
for the government."

Tax Freedom Day

To measure the total tax burden on individual taxpayers, experts have devised a formula to calculate how much you have to work to pay all your taxes. If you began paying your taxes January 1 with your salary and spent no money until taxes were paid off, the day you started paying for your personal necessities is called Tax Freedom Day. In 1929, the beginning of the Great Depression, tax freedom day was Feb. 9; in 1993, it was May 3. Looked at another way, while you would have spent 52 minutes out of each eight-hour day to earn enough money for a day's worth of taxes in 1929, you now spend 2 hours and 41 minutes. In other words, you spend 3.10 times more of your annual income on taxes now than you would have 60 years ago.

TAX FREEDOM DAY

		Tax bite in the eight-hour day[2]		
Year	Tax Freedom Day[1]	Total	Federal	State/Local
1929	Feb 9	0:52	0:19	0:33
1940	Mar. 8	1:29	0:45	0:44
1950	Apr. 3	2:02	1:30	0:32
1960	Apr. 16	2:20	1:40	0:40
1970	Apr. 26	2:32	1:40	0:52
1980	May 1	2:40	1:48	0:52
1985	May 1	2:38	1:44	0:54
1990	May 3	2:41	1:45	0:56
1991	May 2	2:41	1:45	0:56
1992	May 3	2:40	1:42	0:58
1993	May 3	2:41	1:43	0:58

1 The date on which the average person would finish paying federal, state and local taxes if all earnings since January 1 were turned over to government to fulfill annual tax obligations. 2 Reflects the amount of time out of each workday that the average person spends earning enough money to pay tax obligations. Source: Universal Almanac, 1994

EXPLANATION OF TABLES AND GRAPHS

The financial review will explain the process by which the government taxes its citizens and then in turn spends the money it collects. While some of the information is similar to financial highlights, the financial review is a more in-depth explanation of the processes and finances of our federal government.

Section One: The Budget and Its Process

• The Expanded Budget gives a more in depth look at the government's receipts and outlays. Unlike the more concise budget offered in financial highlights, the expanded budget goes over the funds appropriated to the individual departments in government, such as the State Department or the Interior Department. In addition, it also indicates the money that goes toward different government programs such as the Food Stamps Program or the Farmer's Home Administration Program.

• The total amount taken in through taxes and other receipts was approximately $1.1 trillion in 1992. The amount spent by the government was approximately $1.4 trillion in 1992. This in turn means that our deficit for 1992 was approximately $.3 trillion.

• Next is a list of the Civilian Employment of the United States and their payrolls. This tells you khow many people the federal government employs and what their salaries are.

• In addition, a Federal Budget Schedule is included. This explains how and when the components of the Federal Budget are decided upon. Congress will receive the president's proposed budget on the 1st Monday after January 3. After that date, the Congress will debate the budget. The final budget must be passed before the beginning of the new fiscal year which begins on October 1. In order to lobby your Congressmen about the budget, you must do so after the first of January and before the first of October.

Section Two: Debt Ownership

This one page of tables shows how America finances its debt. The government sells securities such as U.S. Treasury Bills and Bonds in order to pay for its debt (ie., the accumulation of deficit). These securities have a variety of different maturities and are owned by a variety of different agents — citizens, foreigners, corporations, pension funds, etc. The majority of debt is owned by our own citizens — roughly 80%.

Section Three: Taxes

In order to get money to pay for all its functions, the government taxes its citizens. The chart entitled Cost of Collecting Federal Taxes and Collections by Principal Sources shows how the U.S. collects its taxes. The majority of taxes comes from income and profit — either from an individual or a corporation. The second most important tax is the employment tax, ie., the Social Security tax.

In 1992, the government collected $1.1 trillion dollars. The average tax "per capita" or per person in the U.S. was $4,375. If, however, we exclude non-workers from our calculation — like children — we find that the average federal tax bill per worker in the U.S. was just over $10,000.

The table labeled Federal Income Tax Comparisons gives an example of the amount of taxes that we had to pay for selected years. For instance, if you were single and had an income of $30,000 you probably paid about $3,833 in federal taxes. Federal Income taxes are progressive. This means that the higher income you have, the greater a percentage of that income you have to pay to the federal government. Since 1975, taxes have decreased because the large tax cuts of the 1980s under President Reagan.

In addition, the individual corporate income tax schedules are included. These give rough estimates of what tax rate you will have to pay depending on the income that you or your company brings in. Again, we can see that the tax system is progressive.

On the opposite page, we see a listing of Who Must File for taxes and also a list of the major changes in our federal tax methods. Together these changes are known as the Omnibus Budget Reconciliation Act of 1993 or OBRA 93.

This and more information is available to us through the Internal Revenue Service. As taxpayers, we have the rights guaranteed to us by the Taxpayer Bill of Rights to demand to know everything about how we are taxed and where our tax money goes.

EXPANDED FEDERAL BUDGET

THE FEDERAL BUDGET — The following gives a more in-depth budget than the financial highlights. Receipts are all the money the government takes in through taxes. Outlays are all the money the government spends either in service or transfer type payments.

U. S. Budget Receipts and Outlays — 1989-1992

Classification:	*Fiscal 1989*	*Fiscal 1990*	*Fiscal 1991*	*Fiscal 1992*
NET RECEIPTS				
Individual income taxes	$445,690	$466,884	$467,827	$476,465
Corporation income taxes	$103,291	$93,507	$98,086	$100,270
Social insurance taxes and contributions:				
Federal old age and survivors insurance	$240,595	$255,031	$265,503	$273,137
Federal disability insurance	$23,071	$26,625	$28,382	$29,289
Federal hospital insurance	$65,396	$68,556	$72,842	$79,109
Railroad retirement fund	$3,798	$3,679	$3,799	$3,957
Total employment taxes and contributions	**$332,859**	**$353,891**	**$370,526**	**$385,491**
Other insurance and retire m't.				
Unemployment	$22,011	$21,635	$20,922	$23,410
Federal employees retir em't	$4,428	$4,405	$4,459	$4,683
Non-federal employees	$119	$117	$108	$105
Total social insurance taxes and contributions	**$359,416**	**$380,047**	**$396,016**	**$413,689**
Excise Taxes	$34,386	$35,345	$42,402	$45,570
Estate and gift taxes	$8,745	$11,500	$11,138	$11,143
Customs duties	$16,334	$16,607	$15,949	$17,359
Deposits of earnings — Federal Reserve Banks	$19,604	$24,319	$19,158	$22,920
All other miscellaneous receipts	$3,235	$2,997	$3,688	$4,275
Net Budget Receipts	$990,701	$1,031,308	$1,054,265	$1,091,692
NET OUTLAYS				
Legislative Branch	$2,095	$2,244	$2,296	$2,677
The Judiciary	$1,492	$1,641	$1,989	$2,295
Executive Office of the President:				
The White House Office	$27	$30	$32	$36
Office of Mgmt. & Budget	$42	$44	$53	$54
Total Executive Office	$124	$157	$193	$190
Funds approriated to the President:				
International security assistance	$1,012	$8,352	$9,531	$7,203
Multinational assistance	$1,492	$1,695	$1,520	$1,717
Agency for International Dvlpt.	$1,215	$1,773	$1,835	$2,142
International Dvlpt. Assistance	$2,780	$3,528	$3,444	$4,029
Total funds appropriated to the President	$4,257	$10,086	$11,724	$11,108
Agriculture Department:				
Food stamp program	$13,725	$15,923	$19,649	$22,800
Farmer's Home Admin.	$7,608	$6,713	$6,629	$4,455
Forest service	$2,944	$2,934	$3,001	$3,293
Total Agriculture Department	$48,316	$46,012	$54,119	$56,436
Commerce Department:				
Total Commerce Department	$2,571	$3,734	$2,585	$2,567
Bureau of the Census	$557	$1,575	$451	$302
Defense Department:				
Military personnel	$80,676	$75,622	$83,439	$81,171
Operation and maintenance	$87,001	$88,340	$101,769	$92,042
Procurement	$81,620	$80,972	$82,028	$74,881
Research, dvlpt., test, evaluation	$37,002	$37,458	$34,589	$34,632
Military construction	$5,275	$5,080	$3,497	$4,262
Total Defense Dept.(Military)	$294,881	$289,755	$261,925	$286,632
Defense Department (civil)	$23,450	$24,975	$26,543	$28,265

EXPANDED FEDERAL BUDGET

U. S. Budget Receipts and Outlays — 1989-1992, cont'd:

Classification:	*Fiscal 1989*	*Fiscal 1990*	*Fiscal 1991*	*Fiscal 1992*
NET OUTLAYS (cont'd.)				
Education Department	$21,608	$23,109	$25,339	$26,047
Energy Department	$11,387	$12,023	$12,459	$15,439
Health & Human Services Dept.:				
Food and Drug Administration	$510	$553	$648	$752
National Institutes of Health	$6,992	$7,492	$7,677	$8,376
Public Health Service	$12,250	$14,007	$15,348	$17,447
Health Care Financing Adm.	$163,028	$184,893	$205,776	$239,366
Total Health/Human Svcs. Dept.	$172,301	$193,679	$217,969	$257,961
Social Security (Off Budget)	$227,473	$244,998	$266,395	$281,418
Housing and Urban Dvlpt. Dept.	$19,680	$20,167	$22,751	$24,470
Interior Department	$5,308	$5,795	$6,095	$6,555
Justice Department:				
Federal Bureau of Investigation	$1,528	$1,473	$1,695	$1,832
Total Justice Department	$6,232	$6,507	$8,244	$9,826
Labor Department:				
Unemployment Trust Fund	$18,730	$20,250	$28,434	$41,294
Total Labor Department	$22,657	$25,316	$34,040	$47,193
State Department	$3,722	$3,979	$4,252	$5,007
Transportation Department:				
Federal Aviation Adm.	$5,740	$6,391	$7,241	$8,155
Total Transportation Dept.	$26,607	$28,637	$30,503	$32,560
Treasury Department:				
Internal Revenue Service	$11,049	$12,053	$13,689	$17,904
Interest on the public debt	$240,863	$264,853	$285,472	$292,330
Total Treasury Department	$230,566	$255,264	$276,352	$293,428
Veterans Affairs Department	$30,041	$28,998	$31,214	$33,737
Environmental Protection Agency	$4,906	$5,108	$5,770	$5,932
General Services Administration	-$462	-$123	$487	$469
Nat. Aeronautics/Space Admin.	$11,036	$12,429	$13,878	$13,961
Office of the Personnel Mgmt.	$29,073	$31,949	$34,808	$35,596
Small Business Administration	$85	$692	$613	$394
Selected independent agencies:				
Action	$163	$169	$192	$194
Board for Int'l. Broadcasting	$199	$208	$223	$210
Corporation for Public Broadcasting	$228	$229	$299	$327
District of Columbia	$538	$578	$671	$691
Equal Employment Opportunity Commission	$182	$181	$192	$209
Export-Import Bank of the U.S.	$47	$357	-$88	-$119
Federal Communication Comm.	$49	$79	$66	$78
Federal Deposit Insurance Corp.	$2,847	$6,429	$7,363	$3,666
Federal Trade Commission	$65	$57	$60	$71
Interstate Commerce Comm.	$44	$43	$45	$40
Legal Services Corporation	$309	$291	$344	$329
Nat. Archives & Record Adm.	$71	$157	$172	$226
Nat. Foundation on the Arts and Humanities	$309	$307	$325	$331
Nat. Labor Relations Board	$136	$141	$143	$155
National Science Foundation	$1,752	$1,838	$2,081	$2,249
Nuclear Regulatory Comm.	$189	$221	-$1	$50
Railroad Retirement Board	$4,315	$4,477	$4,358	$4,643
Securities & Exchange Comm.	$140	$129	$143	$117
Smithsonian Institution	$288	$302	$340	$378
Tennessee Valley Authority	$348	-$312	$740	$1,469
U. S. Information Agency	$888	$888	$1,001	$1,050
Total independent agencies	$33,770	$73,666	$81,217	$18,876
Undistributed offsetting receipts	-$89,155	-$99,025	-$110,005	-$117,118
Net Budget Outlays	$1,144,020	$1,251,776	$1,323,757	$1,381,895
Less net receipts	$990,701	$1,031,308	$1,054,265	$1,091,692
Deficit	-$153,319	-$220,469	-$269,492	-$290,204

GOVERNMENT PAYROLLS

1993 Annual Salaries of Federal Officials:

President of the U. S.	$200,000 [1]
Senators and Representatives	$133,000
Vice President of the U. S.	$171,500 [2]
President Pro Tempore of Senate	$148,000
Cabinet Members	$148,400
Majority & Minority Leader of the Senate	$148,400
Deputy Secretaries of State, Defense, Treasury	$133,600
Majority & Minority Leader of the House	$148,400
Deputy Attorney General	$133,600
Speaker of the House	$171,500
Secretaries of the Army, Navy, Air Force	$133,600
Chief Justice of the United States	$171,500
Under Secretaries of executive departments	$123,100
Associate Justices of the Supreme Court	$164,100

(1) Plus taxable $50,000 for expenses and a nontaxable sum (not to exceed $100,000 a year) for travel expenses. (2) Plus taxable $10,000 for expenses.

NOTE: All salaries shown above are taxable. (Source: Office of Personnel Management).

Financial Review

Civilian Employment of the Federal Government in May 1993

Source: Workforce Analysis and Statistics Division. U. S. Office of Personnel Management. (Payroll in thousands of dollars for the month of May 1993).

	ALL AREAS	
Agency	Employment	Payroll
Total, all agencies[1]	3,033,215	$10,323,268
Legislative Branch	38,779	157,762
Congress	20,695	66,417
U. S. Senate	7,723	24,698
House of Rep. Summary	12,954	41,633
Comm. on Scty. & Coop in Eur.	18	86
Architect of the Capitol	2,334	9,238
Botanic Garden	51	216
Competit Policy Council	6	28
Congressional Budget Office	239	1,631
Copyright Royalty Tribunal	8	65
General Accounting Office	5109	31,747
Government Printing Office	4,775	22,350
John C. Stennis Ctr. Pub. Dev.	6	16
Library of Congress	4,999	23,358
Nat. Comm. on AIDS Syndrome	11	44
Nat. Comm. Prev. Infant Mort.	10	27
Office Technology Assessment	217	1,301
U. S. Tax Court	319	1,324
Judicial Branch	28,075	133,183
Supreme Court	371	1,094
U. S. Courts	27,618	131,639
U. S. Court of Vets. Appeals	86	450
Executive Branch	2,966,361	10,032,323
Exec. Ofc. of the President	1,991	7,598
White House Office	559	1,798
Ofc. of Vice President	23	105
Ofc. of Mgmt. & Budget	564	2,456
Office of Administration	241	715
Council Economic Advisors	33	133
Council on Environ. Qual.	23	83
Office of Policy Development	52	190
Executive Residence at White House	93	581
National Crit. Materials Council	2	8
National Security Council	65	240
National Space Council	7	5
Office of National Drug Control	90	351
Office of Science & Technology Policy	39	110
Office of U. S. Trade Rep	200	923
Executive Departments	2,001,621	6,968,252
State	26,220	153,086
Treasury	165,530	743,467
Defense, Total	941,608	2,731,443
Department of the Army	306,562	827,905
Army, Military Func. Total	275,857	751,411
Army, Civil Func. Total	30,705	76,494
Corps of Engineers	30,565	76,170
Cemeterial Expenses	140	324
Department of the Navy	285,079	898,000
Department of the Air Force	196,074	557,131
Defense Log Agency	64,120	178,758
Other Defense Activities	89,773	269,649
Justice	98,022	463,622
Interior	84,736	335,269
Agriculture	123,057	464,622
Commerce	38,651	177,589
Labor	17,609	88,358
Health and Human Services	132,406	585,517
Housing and Urban Development	13,208	65,684
Transportation	69,922	302,919
Energy	20,637	124,146
Education	5,001	26,508
Veterans Affairs	265,014	706,022
Independent Agencies	962,749	3,056,473
Action	418	2,196
Environmental Protection Agency	18,478	98,110
Equal Employment Opp. Comm.	2,938	14,475
Federal Deposit Ins. Corp.	21,589	123,339
Federal Emergency Mgmt. Agency	4,117	19,265
General Services Admin.	20,780	95,503
National Archives & Recds. Admin.	3,133	9,270
National Aero Space Admin.	25,149	148,159
Nuclear Regulatory Comm.	3,542	17,195
Office of Personnel Mgmt.	6,642	24,985
Panama Canal Commission	8,495	27,934
Securities & Exchange Commission	2,697	16,381
Small Business Admin	5,363	25,461
Smithsonian, Summary	5,491	22,862
Tennessee Valley Authority	19,145	73,470
U. S. Information Agency	8,298	33,960
U. S. Int'l. Dev. Coop. Agency	4,385	26,413
U. S. Postal Service	779,606	2,166,456

(1) Included in total are other independent agencies with fewer than 2,500 employees

THE FEDERAL BUDGET PROCESS

The schedule listed below shows the steps and the time frames that the government goes through in order to create our nation's budget.

Source: Executive Office of the President, Office of Management and Budget and The World Alamanac and Book of Facts 1994.

CBO = Congressional Budget Office   GRH = Gramm-Rudman-Hollings (Balanced Budget and Emergency Deficit Control Act of 1985)   OMB = Office of Management and Budget.

EXECUTIVE BUDGET PROCESS	TIMING	CONGRESSIONAL BUDGET PROCESS
Agencies subject to executive branch review submit initial budget request materials.	Sept. 1	
Fiscal year begins: President's initial GRH sequester order take effect (amounts are withheld from obligation pending issuance of final order).	Oct. 1	Fiscal year begins.
	Oct. 10	CBO issues revised GRH report to OMB and Congress.
OMB reports on changes in initial GRH estimates and determinations resulting from legislation enacted and regulations promulgated after its initial report to Congress. President issues final GRH sequester order, effective immediately, and transmits message to Congress within 15 days of final order. Agencies not subject to executive branch review submit budget request materials.	Oct. 15	
	Nov. 15	Comptroller General issues GRH compliance report.
Legislative Branch and the judiciary submit budget request materials.	Nov.-Dec.	
President transmits budget to Congress.	1st Mon. after Jan. 3	Congress receives the President's budget.
OMB sends allowance letters to agencies.	Jan.-Feb.	
	Feb. 15	CBO reports to the Budget Committees on the President's budget.
	Feb. 25	Committees submit views and estimates to Budget Committee in their own house.
OMB and the President conduct reviews to establish presidential policy to guide agencies in developing the next budget.	Apr.-June	
	Apr. 1	Senate Budget Committee reports concurrent resolution on the budget.
	Apr. 15	Congress completes action on concurrent resolution.
	May 15	House may consider appropriations bills in the absence of a concurrent resolution on the budget.
	June 10	House Appropriations Committee reports last appropriations bill.
	June 15	Congress completes action on reconciliation legislation.
	June 30	House completes action on annual appropriations bills.
President transmits the mid-session review, updating the budget estimates.	July 15	Congress receives mid-session review of the budget.
OMB provides agencies with policy guidance for the upcoming budget.	July-Aug.	
Date of "snapshot" of projected deficits for the upcoming fiscal year for initial OMB and CBO GRH reports.	Aug. 15	
	Aug. 20	CBO issues its initial GRH report to OMB and Congress.
OMB issues its initial GRH report providing estimates and determinations to the President and Congress.	Aug. 25	
President issues initial GRH sequester order and sends message to Congress within 15 days.		

FINANCING AMERICA'S DEBT

Public Debt of the U.S. *(Source: Bureau of Public Debt, U.S. Department of Treasury and The World Almanac and Book of Facts, 1994).*

Fiscal Year	Debt (billions)	Per. cap. (dollars)	Interest paid (billions)	% of federal outlays
1977	$698.8	$3,170	$41.9	10.2
1978	771.5	3,463	48.7	10.6
1979	826.5	3,669	59.8	11.9
1980	907.7	3,985	74.9	12.7
1981	997.9	4,338	95.6	14.1
1982	1,142.0	4,913	117.4	15.7
1983	1,377.2	5,870	128.8	15.9
1984	1,572.3	6,640	153.8	18.1
1985	1,823.1	7,598	178.9	18.9
1986	2,125.3	8,774	190.2	19.2
1987	2,350.3	9,615	195.4	19.5
1988	2,602.3	10,534	214.1	20.1
1989	2,857.4	11,545	240.9	21.0
1990	3,223.3	13,000	264.8	21.1
1991	3665.3	14,436	285.4	21.5
1992	4,064.6	15,846	292.3	21.1

Note: Fiscal year ends September 30.

Interest-bearing Public Debt Securities by Kind of Obligation for 1993

	millions of dollars
Total Interest Bearing Public Debt Securities	4,408,567
Marketable Securities	2,904,910
Treasury Bills	658,381
Treasury Notes	1,734,161
Treasury Bonds	497,367
Nonmarketable Securities	1,503,657
U.S. Savings Bonds	167,024
Foreign Government and Public Securities	42,459
Government Account	1,114,289
Other	179,886

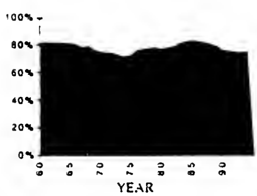
Maturity Distribution of Securities Held by Private Investors for 1993

	millions of dollars
Amount Outstanding Privately Held	2,562,336
Maturity Class	
Within 1 year	858,135
1 to 5 years	978,714
5 to 10 years	306,663
10 to 20 years	94,346
Over 20 years	324,479
Average Length	
Years	5
Month	10

Estimated Ownership of Public Debt by Private Investors *September 1993*

	billions of dollars
Total	2,938.0
Commercial Banks	306.0
Non Bank Investors	2,677.0
Individuals	305.8
Savings Bonds	169.1
Other Securities	136.7
Insurance Companies	210.0
Money Market Funds	75.2
Corporations	215.6
State & Local Government	558.0
Foreign	592.3
Other	720.0

Percentage of U.S. Debt Owned by Americans



Financial Review

TAXES

1993 Individual Tax Rates

There are four tax rates for 1993: 15%, 28%, 31% and 36%. The dollar bracket amounts are adjusted each year for inflation.

Tax Rate	Taxable Income
Single	
15%	$0-22,100
28%	$22,101-53,500
31%	$53,100-115,000
36%	$115,001-250,000
Married Filing Jointly or Widow(er)	
15%	$0-36,900
28%	$36,901-89,150
31%	$89,151-140,000
36%	$140,001-250,000
Married Filing Separately	
15%	$0-18,450
28%	$18,451-44,575
31%	$44,576-70,000
36%	$70,001-125,000

Tax Rate	Taxable Income
Head of Household	
15%	$0-29,600
28%	$29,601-76,400
31%	$76,401-127,500
36%	$127,501-250,000

There is also a 10% surtax on taxable incomes over $250,000. This provision creates a marginal top tax rate of 39.6%. The maximum tax rate on net capital gains for an individual, estate or trust is 28%.

1993 Corporate Income Tax Rates

Taxable Income	*Tax Rate*
$0-50,000	15%
$50,001-75,000	25%
$75,001-10 million	34%
over $10 million	35%

Above $15 million there is an additonal 5% tax and above $18.3 million corporations pay a flat rate of 35%. In addition, personal service corporations such as attorneys or doctors also pay a flat rate of 35%.

COST OF COLLECTING FEDERAL TAXES AND COLLECTIONS BY PRINCIPAL SOURCES

	1992	1991	1990	1989	1988	1970
U. S. population (in thousands)	256,167	252,901	251,329	249,412	246,329	204,878
Number of IRS employees	116,673	115,628	111,858	114,758	114 873	68,683
Cost to govt. of collecting $100 in taxes	$0.58	$0 56	$0.52	$0.51	$0.54	$0.45
Tax per capita	$4,375 27	$4,343.84	$4,203.12	$4,062.84	$3,792.15	$955.31
Collections by principal sources (in thousands of dollars)	$1,120,799,558	$1,086,851,401	$1,056,365,652	$1,013,322,133	$935,106,594	$195,722,096
Income and profits taxes						
Individual	557,723,156	546,876,876	540,228,408	515,731,504	473,666,566	103,651,585
Corporation	117,950,796	113,598,569	110,016,539	117,014,564	109,682,554	35,036,983
Employment taxes	400,080,904	384,451,220	367,219,321	345,625,586	318,038,990	37,449,188
Estate and gift taxes	11,479,116	11,473,141	11,761,939	8,973,146	7,784,445	3,680,076
Alcohol taxes	NOTE 4	NOTE 4	NOTE 4	NOTE 4	NOTE 4	4,746,382
Tobacco taxes	NOTE 4	NOTE 4	NOTE 4	NOTE 4	NOTE 4	2,094,212
Manufacturers' excise taxes	NOTE 3	NOTE 3	NOTE 3	NOTE 3	NOTE 3	6,683,061
All other taxes	33,565,587	30,451,596	27,139,445	25,977,333	25,934,040	2,380,609

NOTE: For fiscal year ending September 30th. NOTE 2: Alcohol and tobacco tax collections are included in the "All other taxes" amount. NOTE 3: Manufacturers' excise taxes are included in the "All other taxes" amount. NOTE 4: Alcohol and tobacco tax collections are now collected and reported by the Bureau of Alcohol, Tobacco, and Firearms. *Source*: IRS 1992 Annual Report.

Federal Income Tax Comparisons:

Taxes at Selected Rate Brackets after Standard Deductions and Personal Exemptions:

Adjusted Gross Income	*Single return listing no dependents*				*Joint return listing two dependents*			
	1993	*1992*	*1991*	*1975*	*1993*	*1992*	*1991*	*1975*
$10,000	*$593*	*$615*	*$668*	*$1,506*	*$-1,511*	*$-1,384**	*$1,235**	*$829*
$20,000	*2,093*	*2,115*	*2,168*	*4,153*	*236*	*408*	*702*	*2,860*
$30,000	*3,833*	*3,960*	*4,201*	*8,018*	*2,160*	*2,220*	*2,355*	*5,804*
$40,000	*6,633*	*6,760*	*7,001*	*12,765*	*3,660*	*3,720*	*3,855*	*9,668*
$50,000	*9,433*	*9,560*	*9,801*	*18,360*	*5,160*	*5,220*	*5,576*	*14,260*

NOTE (1) For comparison purposes, tax rate schedules were used. NOTE (2) Refund was based on a basic earned income credit for families with dependent children.

Who Must File a Return

You must file a return if you are:	*and your gross income is at least:*
• Single (legally separated, divorced, or married living apart from spouse with dependent child) and are under 65	$6,050
• Single (legally separated, divorced or married living apart from spouse with dependent child) and are 65 or older	$6,950
• Head of household under age 65	$7,800
• Head of household over age 65	$8,700
• Married, filing jointly, living together at end of year (or at date of death of spouse), and both are under 65	$10,900
• Married, filing jointly, living together at end of year (or at date of death of spouse), and one is 65 or older	$11,600
• Married, filing jointly, living together at end of year (or at date of death of spouse), and both are 65 or older	$12,300
• Married, filing separate return, or married but not living together at end of year	$2,350

Free Taxpayer Publications

The IRS publishes over 100 free taxpayer information publications on various subjects.

One of these, Publication 910, Guide to Free Tax Services, *is a catalog of the free services the IRS offers.*

You can order these publications and any tax forms or instructions you need by calling the IRS toll-free at 1-800-829-3676.

Financial Review

Tax Highlights
Omnibus Budget Reconciliation Act 1993

Source: World Almanac 1994

Individual Income Taxes. The act increase the top tax rate to 36% for joint filers with taxable income over $140,000, heads of households with taxable income over $127,500, and singles with taxable income of more than %115,000. Congress also added a 10% surcharge on taxable income of more than $250,000. This provision creates a marginal top tax rate of 39.6% and is retroactive to January 1, 1993.

Social Security Benefits. Effective January 1, 1994, retirees whose incomes, including half their Social Security benefits, exceed $34,000 for singles or $44,00 for married couples filing jointly will pay income tax on up to 85% of their benefits.

Estate and Gift Taxes. The act reinstates the 1992 tp tax rate of 52% on estates between $2.5 million and $3 million, and 55% on estates of more than $3 million. On taxable estates above $10 million an additional tax of 5% of the transfer above $10 million.

Corporate Tax Rates. The act increases the top tax rate for corporations with taxable income over $10 million per year from 34% to 35%. The tax rate for qualified personal service corporations also increases from 34% to 35%

Moving Expense Deduction. For expenses incurred after 1993, moving expense deductions associated with a new job will be limited. Deductions for meals while traveling, living expenses in temporary quarters, and the cost of selling an old residence or buying or renting a new residence will no longer be deductible.

Business Meals and Entertainment. The act reduces the proportion of qualified business meals and entertainment costs that can be deducted as business expenses up to 50% starting in 1994. Congress eliminated the deduction as a business expense of dues in business, social, athletic, luncheon, sporting, and country clubs, including airport and hotel clubs.

Lobbying Expenses. The act eliminates the business deduction for lobbying Congress and federal, state, and local government agencies, beginning in 1994.

Energy Tax. The act imposes a 4.3 cents-per-gallon tax on transportation fuels. Commercial airline fuel is exempt till 1995.

Medicare Tax. In 1994, the $135,000 limit on earned income subject to the payroll tax for Medicare has been repealed. Therefore all wages will be subject to the Medicare tax of 1.45% for both employers and employees. Self-employed individuals will pay a 2.9% Medicare tax on their net self-employed income.

Earned Income Tax Credit. The tax credit rate increases for low-income working taxpayers starting in 1994. A credit of up to $300 is created for childless low income worker over 25 years of age and below 65 years. The Young Child Care Credit and Supplemental Health Insurance Credit are repealed.

Rental Passive Losses. The act allows certain real estate professionals to use losses from rental real estate to offset other nonpassive income, such as wages and self-employment profits.

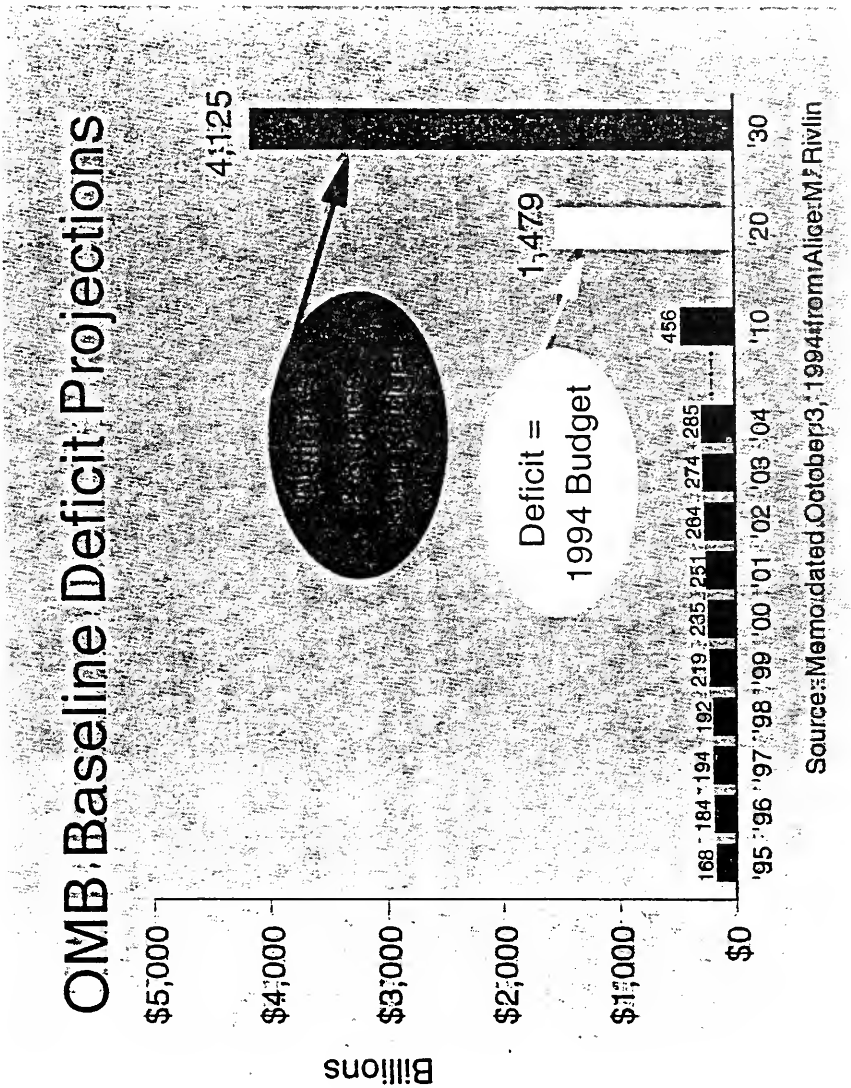
Charitable Contributions. Taxpayers deducting charitable contributions of $250 or more will have to obtain written substantiation from the charity before filing.

Equipment Write-off. Congress elected to allow small businesses to deduct as an expense up to $17,5000 of the cost of new equipment.

Retirement Plans. The new law reduced from $235,840 to $150,000 the level of compensation for which tax-deferred contributions can be made to retirement plans.

Alternative Minimum Tax. Retroactive to January 1, 1993, the 24% AMT rate has been replaced with a two-tiered tax rate of 26% and 28%

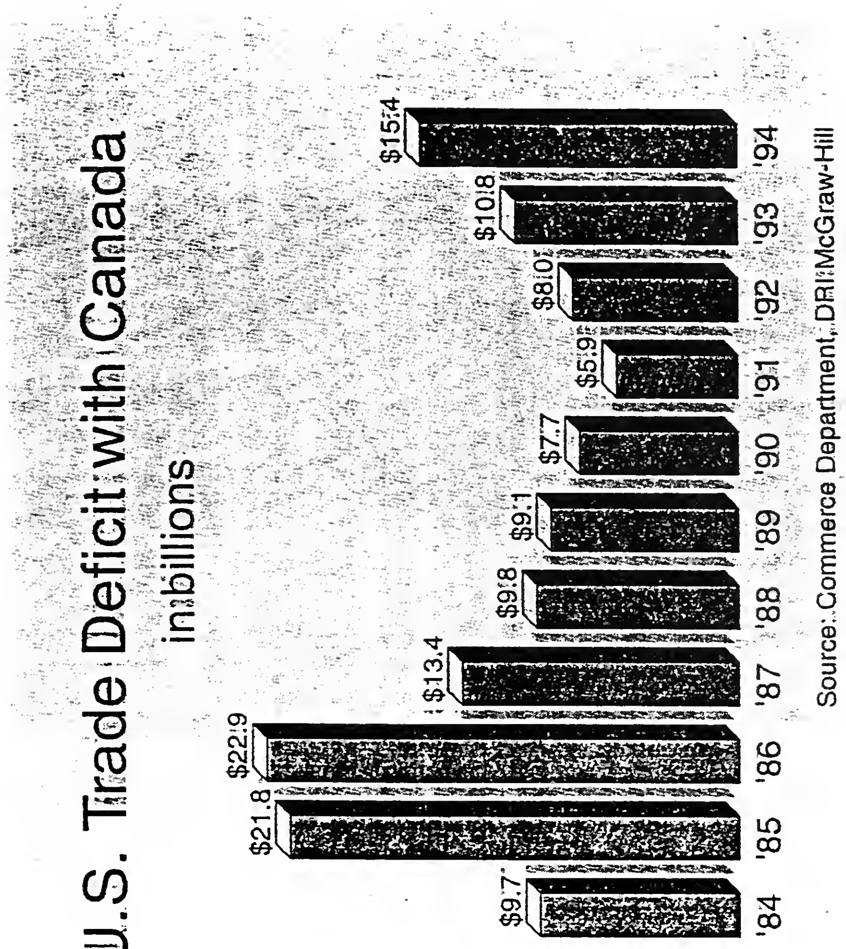
Estates and Trusts. Retroactive to January 1, 1993, the tax rates for the taxable incomes of estates and trust has increased similarly to the individual income tax rate.

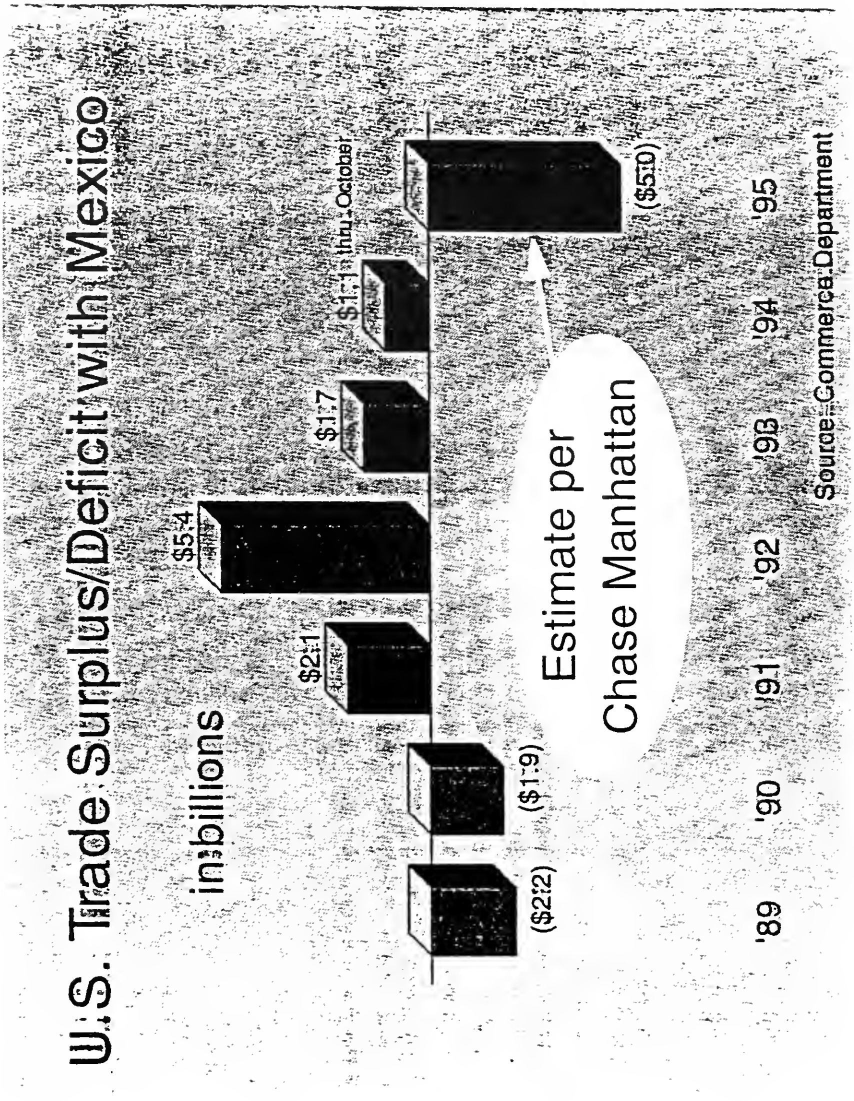


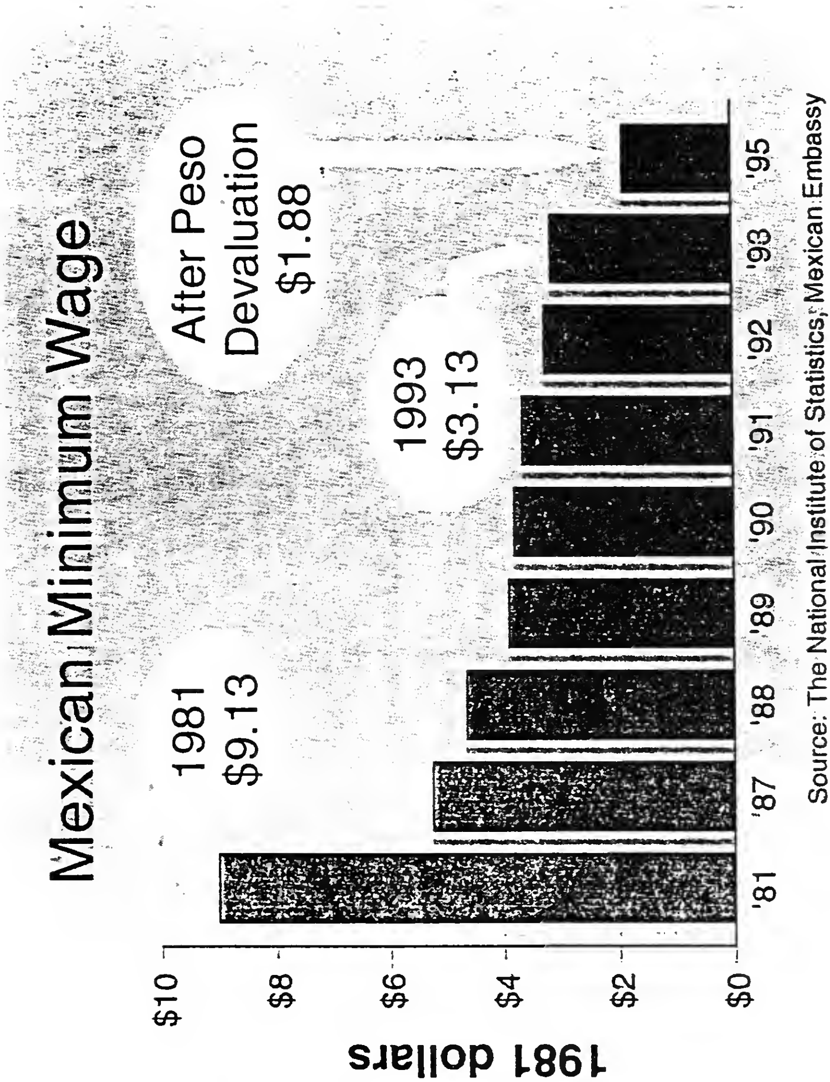
OMB Baseline Deficit Projections
Billions
$5,000
$4,000
$3,000
$2,000
$1,000
$0
168
184
194
192
219
235
251
264
274
285
456
1,479
4,125
'95
'96
'97
'98
'99
'00
'01
'02
'03
'04
'10
'20
'30
Deficit =
1994 Budget
Source: Memo dated October 3, 1994 from Alice M. Rivlin

How Much is $40 Billion?

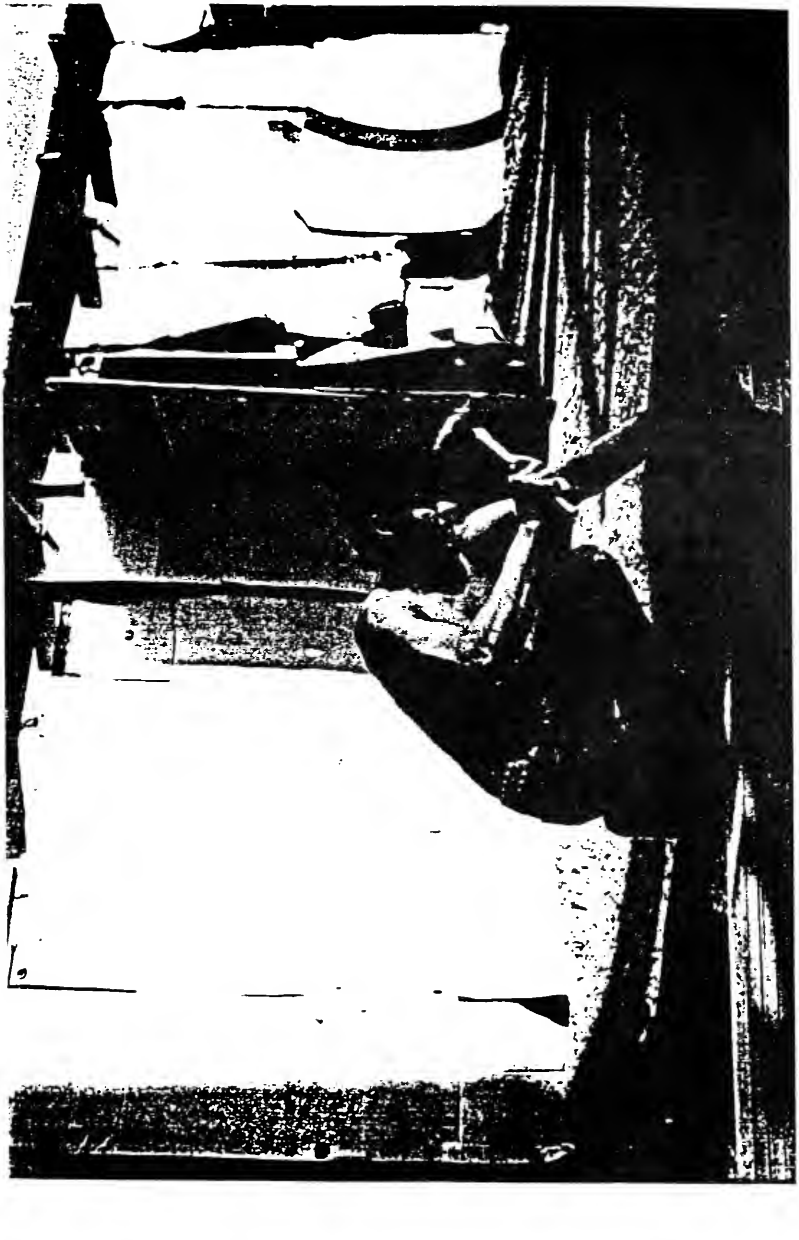
	Billion
The cost to put a man on the moon	$30 B
Total spent by U. S. Government from its birth to World War I	$28 B
Amount spent rebuilding Europe after World War II	$25 B
1995 foreign aid	$16 B
1995 medical research	$12 B
1995 unemployment benefits	$23 B

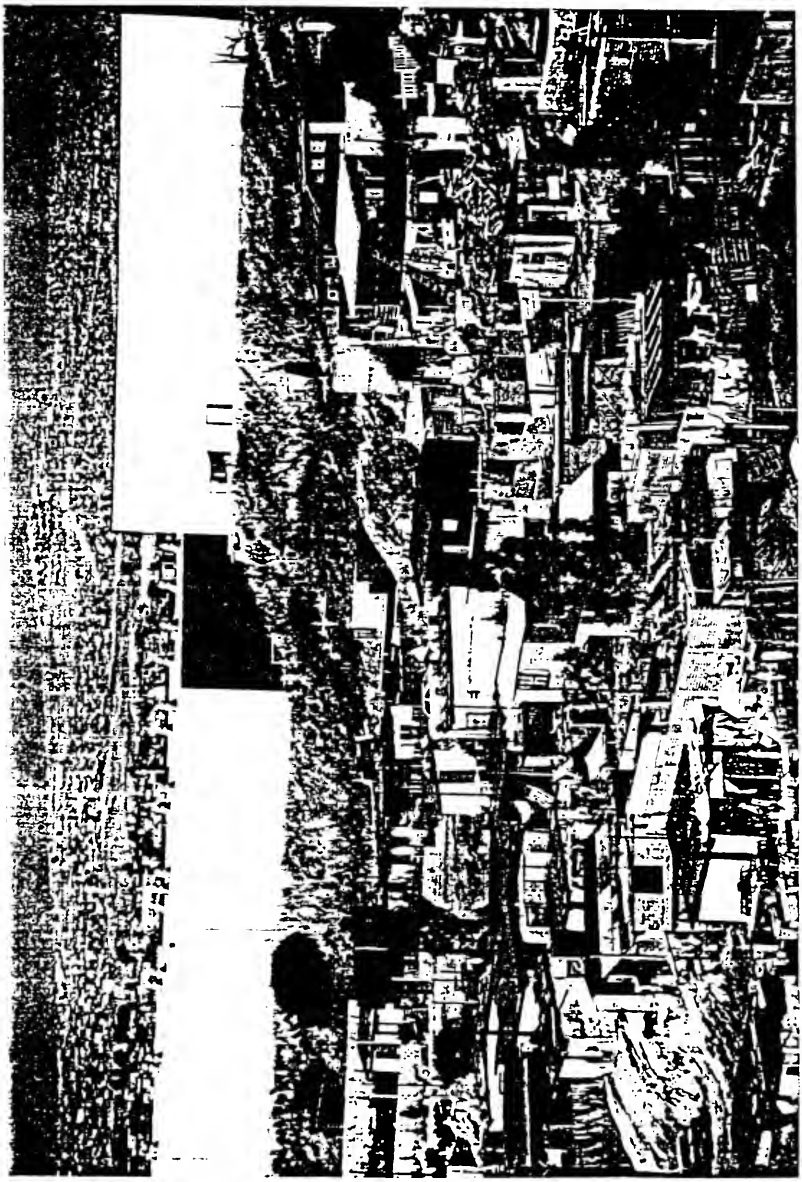

U.S. Trade Deficit with Canada
in billions
$9.7
$21.8
$22.9
$13.4
$9.8
$9.1
$7.7
$5.9
$8.0
$10.8
$15.4
'84
'85
'86
'87
'88
'89
'90
'91
'92
'93
'94
Source: Commerce Department, DRI/McGraw-Hill


U.S. Trade Surplus/Deficit with Mexico
in billions
($2.2)
($1.9)
$2.1
$5.4
$1.7
$1.1 thru October
($5.0)
Estimate per Chase Manhattan
'89
'90
'91
'92
'93
'94
'95
Source: Commerce Department



Mexican Minimum Wage
1981
$9.13
1993
$3.13
After Peso
Devaluation
$1.88
1981 dollars
$10
$8
$6
$4
$2
$0
'81
'87
'88
'89
'90
'91
'92
'93
'95
Source: The National Institute of Statistics; Mexican Embassy





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BANK NEWS RELEASE 95/S57

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World Bank announces action plan to support Mexican reforms

Emphasis on banking, social sectors and infrastructure privatization

MEXICO CITY, February 9, 1995 -- The World Bank announced today that it is prepared to provide immediate assistance in support of measures designed to restore sustained growth to Mexico's economy in the aftermath of the country's currency crisis.

Today's announcement follows talks here on Mexico's medium term economic program between Finance Minister Guillermo Ortiz Martinez and World Bank Managing Director Richard Frank.

Frank said that the World Bank welcomed the international package of loan guarantees announced last week by the President of the United States. "These measures are designed to address the short term financial crisis and should help to restore confidence in an economy that we believe is fundamentally sound," Frank said. "It is however, critically important for the government to continue with the policies and reform programs which have been the basis for the progress Mexico has made in recent years. The assistance from the World Bank will support the government's medium term economic plan which is designed to strengthen those sectors that have been affected by the currency crisis and ensure that the economy continues on the fundamentally sound course it had been following. We are also committed to assisting the government in its determination to help those people -- particularly the poorest members of society -- on whom recent events have had the severest impact."

Frank disclosed that for the past month, teams of experts from the World Bank have been working with the Mexican authorities on the priority areas for the international lending body's assistance. The Bank is reviewing the projects it is financing which are currently underway in Mexico, as well as those in preparation, to ensure that changes in priorities required by the need for enhanced budget austerity are fully reflected.

Frank said that the Mexican authorities have asked the Bank to focus its lending and technical assistance in three priority areas:

- The Bank will expand its program of assistance to strengthen the commercial banking sector. A Financial Sector Technical Assistance loan was approved on January 24, 1995, as an initial step to help improve the bank regulation and supervision process and to support financial sector reform. Building on this, the Bank will now extend its assistance to Mexican banking authorities in addressing the restructuring needs of the commercial banks. The program is also designed to improve institutions and mechanisms for dealing with financial distress and to minimize the related costs.

- The Bank will support efforts to protect the social and economic well-being of the poorest and most vulnerable members of Mexican society from the consequences of the crisis. Special attention will be paid to expansion of health, nutrition and educational services in the poorest regions of the country.

- Given the infrastructure needs of a growing economy, there is a critical role for the private sector in ensuring that these investments are carried out as efficiently as possible. The Bank will assist the government in this area. In addition to providing advice on the lessons of international experience, the Bank will also assist with the formulation of an appropriate institutional and regulatory framework for privatization.

The Mexican authorities and the World bank have initiated work to define a program of support in these areas. A series of operations will be prepared for World Bank financing as a part of this program. The Bank may commit up to $2 billion during 1995 for these operations.

These initiatives will build on the extensive support the World Bank has provided to Mexico in recent years. The Bank has made commitments of $8.7 billion to Mexico over the last five years in support of economic reform, social programs, essential infrastructure and the environment. In fiscal year 1994 alone, the Bank committed $1.5 billion, notably for education, environment, and water supply and sanitation.

Frank reaffirmed the Bank's support for the reform measures of recent years. "We believe that once the present crisis is surmounted, the healthy fundamentals will re-assert themselves and permit Mexico to achieve a robust and sustainable rate of economic growth. With the exchange rate at a more attractive level, producers of goods that can be exported, or which were previously imported, should benefit and will lead the recovery."

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BANK NEWS RELEASE 95/50LAC

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WORLD BANK APPROVES $23.6 MILLION LOAN TO HELP IMPROVE MEXICO'S FINANCIAL SECTOR

WASHINGTON, January 24, 1995 – The World Bank approved today a $23.6 million loan to Mexico to help finance a financial sector technical assistance project. The loan will support actions in three critical areas to improve Mexico's financial sector.

Intensive preparation of the project began more than a year ago, and during this period, the Bank has worked closely with the Mexican authorities on both immediate and longer term measures to improve the functioning of the financial sector.

As part of this effort, a reallocation of $1.6 million from a previous industrial restructuring loan was utilized in support of activities to strengthen banking supervision and to improve the regulatory framework for the new defined-contribution pension scheme.

The technical assistance loan supports the government's efforts to improve the safety and soundness of the Mexican financial system during what will now be a more rapid opening to international competition in the provision of financial services.

The loan will also support changes in the Mexican regulatory framework that will permit development of a broader base of institutional investors, allowing a more liquid domestic securities markets. These actions will help Mexico to improve, and utilize more effectively, domestic savings.

Finally, the project will support the preparation of analyses of selected investment issues, including issues surrounding the utilization of the private sector in infrastructure development and operation.

The technical assistance project, coupled with parallel reforms undertaken by the government, will act to help reduce the cost of capital to all firms and to encourage the efficient development of Mexico's financial institutions and securities markets.

The project will include hiring external consultants to assist in the development of specific policies and regulations; commissioning of related studies; financing participation in seminars, advanced training programs, and other human resource development activities; and procurement of necessary hardware, software, and equipment.

NOTE: Money figures are expressed in U.S. dollar equivalents.

The project will be implemented over three years by the Ministry of Finance and Public Credit, and will also benefit four commissions under the Ministry: the National Banking Commission, the National Securities Commission, the National Insurance and Bonding Commission, and the National Retirement Savings System Commission.

The World Bank loan will be disbursed over 3 years. The government of Mexico will provide $7.76 million to cover the balance of project costs, which will total an estimated $31.36 million.

The Bank loan will be made to Nacional Financiera with the guarantee of the United Mexican States. It is for 15 years, including five years of grace, with a variable interest rate, currently at 7.09 percent, linked to the cost of the Bank's borrowings. It also carries an annual commitment charge of 0.25 percent on undisbursed balances.

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The Impact of Recent Developments in Mexico on the Prospects for Capital Flows to the Developing Countries

Statement by Mr. Michael Bruno, Chief Economist and Vice-President
Development Economics, World Bank

It is too early to draw the complete lessons of the recent difficulties in Mexico, but a few important points are already clear. The first such lesson is the importance of maintaining sound macroeconomic fundamentals. Recipient countries need to watch how the overall level of savings and investment is evolving and to ensure that fiscal and current account balances are sustainable. The second lesson relates to the composition of external capital flows; the Mexican case shows how excessive reliance on short term capital flows can bring greater volatility in its wake.

As to the impact on other countries, it is important to recognize that the current situation is very different form the type of systemic debt crisis that occurred in 1982. The policy framework in most of the recipient countries is very much better than it was a decade ago, and prospects for the international economic environment are also much more favorable. While market participants may exhibit some "herd instinct," there are no economic or structural reasons for Mexico's problem to become a generalized financial crisis for the region or for developing countries as a whole.

Finally, as to the prospects for the Mexican economy, these recent developments clearly represent a setback. However, against the background of the macroeconomic and structural reforms that have been adopted over the past decade, the fundamentals of the Mexican economy remain sound and the measures announced over the past few weeks should strengthen the balance of payments and lay the foundations for renewed economic growth.

FOR IMMEDIATE RELEASE

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BANK NEWS RELEASE NO. 95/S50

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MEXICO: PRESIDENT ZEDILLO'S REMARKS ON JANUARY 3, 1995

WASHINGTON, January 3, 1995 --The World Bank supports President Ernesto Zedillo in his determination to promote the economic conditions necessary for a stable investment climate and long-term growth in Mexico. The announcement by the President of a program to correct the current account imbalance and further deepen market-oriented structural reforms is therefore welcome. The direction and depth of the President's economic reform program, which includes wage restraints, a cut in Government expenditures to provide a fiscal surplus, further privatization of public infrastructure, and restraints on credit from the development banks, has set a framework for sustainable growth. The President's program will be supported by tight monetary policy from the autonomous Bank of Mexico to help control inflation.

The World Bank believes that the fundamentals of the Mexican economy are sound. Over the past decade, Mexico has moved from being inward-looking to a dynamic economy that, through its membership in NAFTA and its growing international competitiveness, has opened up new possibilities for all Mexicans. Mexico reduced sharply its barriers to external trade, aggressively privatized public firms, reduced regulations that had previously restrained competition, and liberalized financial markets, including re-privatizing the major commercial banks. As a consequence of the reforms implemented, annual inflation was brought down significantly, the Government budget was balanced, and the public sector debt was reduced by over one-half in terms of its proportion of GDP. This record of reforms has allowed Mexico the means to begin addressing the deep-rooted poverty in parts of the country, such as Chiapas.

The World Bank will continue to work vigorously with Mexico to ensure that the momentum of reform continues and that the needs of the poorest are met. The World Bank's lending has been averaging about US$1.5 billion a year. We will work closely with the Government to deepen the structural reforms of the economy, to improve infrastructure, and to rationalize the public sector through privatization and regulatory reform. We will also continue to address the problem of poverty through loans in health, education, and rural infrastructure targeted particularly to the poorest parts of the country.

(Mr. Edilberto L. Segura, Director of the Bank's Latin America and the Caribbean Country Department II, is available for comments/interviews. His telephone number is (202) 473-8579.)

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BANK NEWS RELEASE NO. 95/24 LAC

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WORLD BANK LENDS $265 MILLION TO MEXICO FOR TECHNICAL EDUCATION AND TRAINING

WASHINGTON, October 28, 1994-- The World Bank has approved a $265 million loan to Mexico to help finance a technical education and training modernization project that is expected to benefit more than 200,000 workers.

The $412 million project will help to improve the quality of the technical education and training in Mexico so that it meets the critical needs of the productive sector in a flexible manner.

During the last decade, Mexico has made substantial advances in the expansion of education and training opportunities, especially in the field of technical and vocational training. Despite the progress, however, technical training in Mexico still does not meet the immediate and future needs of the rapidly changing productive sector.

The project reflects the government's strong commitment to the quality improvement of technical education and training through private sector participation in the design and implementation of training programs, thus making the courses more relevant, responsive, flexible, and effective.

The project will create a National System of Competency Standards, Skills Testing and Certification to establish national competency standards defined by workers and employers for 20 key occupational clusters.

The project will also help selected training institutions, both public and private, redesign their training courses into modular courses based on the new competency standards, by providing for teaching material development, instructor training and equipment updating during the first phase, and by expanding the support to wider range of training institutions during the second phase.

The project will also promote the benefits of the new system of competency standards and certification to potential users of the system by providing financial incentives to targeted individuals and firms to participate in competency-based training.

NOTE: Money figures are expressed in U.S. dollar equivalents.

Finally, the project will support establishment of registries of data pertaining to the new training and certification system for monitoring and evaluation purposes. This component will also include a program of studies to guide project design and evaluation.

The development of programs and training materials for about 130 different training modules are expected to be financed directly through the project, which will be used in about 8,400 public and private training courses.

More flexible, modular training programs will increase the accessibility of skill formation and upgrading to a wide range of people.

At the same time, the project will provide incentives for 158,000 individuals to take skill tests for certification of competencies acquired on the job or through training programs. The project will assist micro, small and medium sized firms to develop competency-based training programs for their employees.

In addition to the World Bank loan, the government of Mexico will provide $118.3 million and the beneficiaries $28.7 million, to cover the balance of project cost.

The $265 million World Bank loan was made to National Financiera, S.N.C. with the guarantee of the United Mexican States. The loan is for 15 years, including five years of grace, with a variable interest rate, currently at 7.1 percent, linked to the cost of the Bank's borrowing. It also carries an annual commitment charge of 0.25 percent on the undisbursed balances.

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BANK NEWS RELEASE NO. 95/14 LAC

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WORLD BANK TO SUPPORT DECENTRALIZATION AND REGIONAL DEVELOPMENT IN MEXICO

WASHINGTON, September 14, 1994 -- The World Bank has approved a $500 million loan to Mexico to support a second decentralization and regional development project in eight of the poorest states in the country. About 10 million rural poor are expected to benefit from the improvement of access roads, water supply, educational and other basic infrastructure.

The project is consistent with the Mexican government's broad strategies for improving poverty alleviation through its Solidarity program and with the Bank's assistance strategy which seeks to expand and improve programs attacking poverty and to strengthen the roles and capabilities of state and municipal authorities in the delivery of services.

Poverty remains a major problem in Mexico. It is estimated that in 1992, 16 percent of the national population of 84 million were living in conditions of extreme poverty, with over half of the extreme poor living in rural areas.

Poverty is concentrated in the southern states; of the eight project states, all but one are located in the southern half of Mexico. These states represent only 32 percent of the country's population but it is estimated that they contain 69 percent of the extreme poor and 54 percent of the population without access to water.

The project's objective is to increase access of rural poor and indigenous communities to basic social and economic infrastructure (especially roads, water supply and schools), and to income-generating activities and thus alleviate poverty.

This project will continue efforts initiated under a first decentralization and regional development project (for which a Bank loan of $350 million was approved on March 1991) to strengthen the participation of poor rural communities in local government investment planning and implementation and the institutional capacity of state and local governments.

NOTE: Money figures are expressed in U.S. dollar equivalents

The Second Decentralization and Regional Development project will benefit poor communities in the states of Chiapas, Guerrero, Hidalgo and Oaxaca (also covered in the first project) and Michoacan, Puebla, Veracruz and Zacatecas.

The $1.1 billion project will finance small-scale community selected and managed works, for water supply, rural roads, school rehabilitation, productive activities, and other small infrastructure priority works. It will do this through the Municipal Funds program and the school rehabilitation (Escuela Digna) program of the Secretariat of Social Development (SEDESOL).

The project will also finance the rehabilitation and maintenance of priority sections of the rural roads network, the provision of potable water to small rural localities, technical assistance and training to support income-generating projects in rural areas, and a program of institutional development and training for municipalities, state agencies and SEDESOL. The project will strengthen the capacity of municipal governments and communities to work together to define and address priority needs in poor rural areas.

The rural water supply investments will result in rising access to water of rural population in the eight states from 48 percent to 63 percent. Of the 50,000 kilometers of earthen, rural roads in the eight states, 29 percent (or 15,600 km) will be improved and maintained, resulting in greater access of about 4 million rural dwellers to social services and economic activities.

In addition to the World Bank loan of $500 million, the federal and project state governments will provide $443 million, and the beneficiary communities the balance of $152 million. The Bank loan will be disbursed over four years.

The World Bank loan was made to National Financiera, S.N.C. (NAFIN), with the guarantee of the United Mexican States. The loan is for 15 years, including five years of grace, with a variable interest rate, currently at 7.1 percent, linked to the cost of the Bank's borrowing. It also carries an annual commitment charge of 0.25 percent on the undisbursed balances.

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HOLD FOR RELEASE

World Bank

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EMBARGO: This press release describes projects scheduled for discussion by the World Bank's Board on Thursday, June 9, 1994. It is embargoed until after approval. A press advisory confirming the Board approval is expected to be issued during the afternoon of June 9.

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David de Ferranti, Chief of the World Bank's Mexico Division, is available for interviews on June 8.

WORLD BANK LENDS $918 MILLION FOR MEXICO'S ENVIRONMENT

WASHINGTON, June 9, 1994 -- Mexico is taking a major step in solving some of its most serious environmental problems, particularly those of its northern border with the United States, with the support of three loans, totalling $918 million, approved today by the World Bank.

This important lending package includes the first operations under a joint program for environmental protection agreed last September between Mexico and the Bank. The program is expected to provide up to $1.8 billion in World Bank loans to Mexico over the next three years.

The first loan, of $368 million, will help finance the Northern Border Environment Project, aimed at improving environmental conditions in five or six border cities, benefitting some 3 million people. The second loan, of $350 million, will help to improve water and sanitation services across Mexico, especially in the poorer areas.

The third loan, of $200 million, is to assist a national program to modernize solid-waste services in medium-size cities. The loans were made to the National Bank of Public Works and Services (BANOBRAS), which will be the main implementing agency for the three projects.

"Mexicans, like their neighbors to the north, are acutely aware of the serious environmental problems that urgently need attention. People want action -- and the Mexican Government is committed to rapid and effective progress in upgrading environmental enforcement and reversing past damage. These three new projects will be a major building block in helping them do that," says David de Ferranti, the World Bank's Division Chief for Mexico.

NOTE: Money figures are expressed in U.S. dollar equivalents.

In addition to the $918 million from the Bank, the Mexican Government is devoting $1.03 billion of its own funds to this effort, bringing the total to $1.95 billion. The funds from the Bank will be disbursed over a five-to eight-year period.

U.S. border communities in California, Texas, New Mexico, and Arizona will also benefit indirectly, to the extent that environmental improvements on the Mexican side of the border, especially in water treatment and air quality, will have spinoff impacts on the U.S. side. Project funding will be available only to Mexican communities, but U.S. communities are in some cases so close by that the benefits will be shared on both sides of the border.

The Mexican Government is strongly committed to this effort. Mexico's extensive environmental problems are a major concern both nationally and globally. Mexico now has a much improved legal, regulatory, and institutional framework for addressing these problems.

Major institutional reforms have been implemented and national actions plans prepared to articulate a development strategy recognizing the essential link between economic growth and environmental protection.

Initiatives are now in process or being planned to address environmental issues in other parts of the country as well. New projects, supported by the World Bank, are facilitating improvements in key sectors nationwide, including water supply and sanitation, solid-waste management, and air quality and urban transport.

The Northern Border

Northern Mexico, and particularly the region that borders the United States, has urgent ecological problems, including serious environmental degradation. These problems stem from a combination of fragile climatic conditions and rapid, largely unplanned economic and urban growth resulting from the boom of the maquiladora industries.

Inadequate water treatment and sanitation have led to massive discharges of untreated wastewater into the region's ecosystems, threatening human health and causing economic losses. Solid waste management is also deficient so that, of the estimated 3,000 metric tons of garbage generated daily, only about 16 percent is disposed of properly.

Hazardous waste disposal has been a major problem in Mexico. Many firms dump dangerous substances improperly. Air pollution is also a serious concern because of heavy traffic and dust from many unpaved roads, especially in unplanned, fast-growing settlements. Enforcement of environmental regulations is still weak, although it has been improving.

Since 1988, Mexico and the United States have been working together to implement the initial phase of a Border Environment plan. The second stage, planned for 1995-97, calls for extensive further steps by both countries. Given the magnitude and complexity of this challenge, the Government of Mexico has requested World Bank support for the efforts on the Mexican side of the border.

The main objective of the Northern Border Environment Project is to improve environmental quality in the border area by assisting Mexican municipal, state and federal authorities to strengthen their environmental planning, management and enforcement capabilities, and carry out priority investments and action plans efficiently.

All these efforts are aimed at helping to preserve the environment, reverse past degradation, reduce health risks, protect biodiversity, and achieve key environmental policy objectives.

The Northern Border Environment Project will benefit the chief environmental enforcement agency, PFPA; the governments of the states of Baja California, Chihuahua, Coahuila, Nuevo Leon, Sonora and Tamaulipas; participating border municipalities; and private small and medium industries.

The project will support about 15 investment subprojects in five or six Mexican border cities which will qualify among 14 cities that can apply for assistance. The subprojects will include water treatment and sanitation, solid waste management, air quality and urban transport.

Cities will present investment proposals based on master plans analyzing environmental needs and priorities. They will be required to meet eligibility criteria for financial soundness, implementation arrangements, technical appropriateness, and environmental goals.

"The project is, in effect, a fund. Border cities will be able to apply to the fund. Those that put forward well-designed proposals that meet all the environmental and other requirements will receive support," added de Ferranti.

The project will provide a line of credit of $560 million for the investment subprojects, including $176 million for water supply, sewerage and waste-water treatment investments, and assistance to develop and implement a system to control wastewater discharges to the sewer system and to collect pollution fees. (These sums include the funds from both the World Bank and the Government.)

The project investment component for improvements in water-supply treatment and sanitation is likely to beneficially affect Mexico's international waterways shared with the United States.

The component to improve solid waste management will also support the development of social safety net programs for waste pickers displaced by the investments.

Funds will also be provided for investment to reduce air pollution caused by inadequate urban transport infrastructure and services. The most serious air quality issue in the border cities is the excessive concentration of minute particulate matter less than 10 microns in diameter (PM-10).

Traffic management, road maintenance and rehabilitation, paving in poor neighborhoods, environmental assessment and pollution control measures, including vehicle inspection and maintenance, will also be financed under the project.

The project further includes institutional strengthening to improve the capabilities of federal, state and municipal authorities to manage environmental clean-up and protection and to accelerate progress, particularly in hazardous-waste management and protection of biodiversity and endangered species.

It also includes a pilot program for mobile hazardous-waste treatment, under which specially equipped trucks will treat some waste on sites (in cases where off-site treatment is not economic or unavailable, or where wastes would otherwise be dumped improperly).

Protection of Ecological Areas

Support will be provided to develop and implement management plans to protect three ecologically important areas in Mexico which are contiguous to national parks and protected areas on the U.S. side. These areas are Alto Golfo and El Pinacate, Sierra del Carmen and Maderas del Carmen, and Laguna Madre de Tamaulipas.

Support will also be provided to the Ministry of Social Development (SEDESOL), BANOBRAS and the National Ecological Institute (INE) to strengthen their project implementation capabilities and develop the next phase of the border improvement effort.

The project is expected to improve substantially the environment through institutional strengthening and investments in water, solid waste, and urban transport improvements. Environmental impact assessments will be prepared for major investments in water and solid waste.

The project will address problems that are presently the source of serious levels of contamination of water, air, and soil; threats to public health; loss of environmental quality; and, where toxic wastes are concerned, danger of calamities such as an explosion in 1992 in Guadalajara caused by gasoline fumes.

Benefits will include significant and direct reductions in these problems for an estimated 3 million people in border cities, resulting in less degradation and diminished risks of illness and environmental disasters, and stronger federal, state, and municipal capabilities, and improved institutional framework for environmental protection.

The Northern Border Environment Project will improve the quality and coverage of environmental services in poor areas in border cities and living conditions in low-income neighborhoods through the road-paving component.

The total project cost is estimated at $762 million. The World Bank loan of $368 million will be disbursed over seven years. The Mexican federal government, state governments, municipalities, and water utilities will provide $394 million.

<u>Water Supply and Sanitation</u>

The Second Water Supply and Sanitation Sector project, for which the Bank has approved a $350 million loan, will continue to support the decentralization process initiated under a previous project, with emphasis on sustainability of investments and addressing environmental concerns. The first loan, of $300 million, was approved in January 1991 and is now almost fully disbursed.

The percentage of people connected to a water supply system (86 percent in 1992) or wastewater disposal (68 percent in 1992) is low compared to Latin American countries in a similar development stage. However, coverage increased annually by more than the population's increase until about 1980. Since then, because of Mexico's debt crisis, budgetary constraints and insufficient attention to the sector up to 1992, coverage more or less matched population growth, stagnating particularly in the final years of the decade. By the end of 1992, progress has been restored through significantly increased investments and a reorganization of the sector.

With the progress during the last two years and the current plans of the Mexican Government, it is expected that a significantly larger percentage of the population will be adequately served by mid-decade. During 1994-97, the sector will have 2 million additional water connections that will provide water to about 13 million people. In addition, 2.4 million new sewerage connections will be installed, covering about 14.4 million people.

The project is also expected to strengthen the institutional capacity of the National Water Commission (CNA) to comply with its legal mandate to assist the local water utilities.

The private sector in Mexico is expected to play an increasing role in infrastructure development. It is already actively participating in the financing, construction and operation of wastewater treatment plants. In addition, the private sector is now beginning to get involved in providing water. Increased private sector participation is expected to improve sector efficiency, help remove budget constraints, and expand service.

The water and sanitation project will help reduce subsidies to the sector by promoting the development of water utilities that are operationally and financially autonomous. It will also support BANOBRAS' effort to enhance its capacity to appraise and supervise subprojects.

The $770 million project will encourage private sector participation by establishing the appropriate legal and technical framework within which to attract private investment, improve the management of water resources overall, and strengthen the sector's capacity to enforce environmental regulations and carry out environmental impact assessments.

The project will benefit urban municipalities by targeting public investment to priority basic infrastructure. Its main component is to provide a line of credit to water utilities to fund civil works for water supply and distribution systems, as well as for wastewater collection and treatment projects.

Improved Water Quality

The water and sanitation project is expected to directly benefit about 10 million people. Improved water quality can be expected to contribute to the control and eventual eradication of cholera and to significant reductions in other gastro-intestinal diseases, which are especially prevalent in the poorer areas of Mexico.

Gastrointestinal diseases, related to unsafe water and lack of sanitation, are still one of the principal causes of deaths, especially among infants, in Mexico. In 1990, intestinal diseases were the principal cause of death in Mexico, with a rate of 32.8 for every 100,000 people. The incidence of diarrhea was 4,342 for every 100,000 people for the same year and showed no improvement by 1992.

Mexico has also been hit hard by the cholera outbreak which has plagued several Latin American countries, with 2,690 cases in 1991 and 8,162 cases in 1992. To control the spread of cholera, a clean water program with funding under the first project was launched in April 1991, aimed at chlorinating all water systems in Mexico.

At the start of the program, 52 percent of water sources were being disinfected; eight months later it reached 83 percent and by November 1993 the level was 96 percent. The emphasis now is to ensure proper and continuous operation of the disinfection systems. Recent statistics are encouraging. Data for the first 32 weeks of 1993 showed a 10 percent decline in the incidence of diarrhea over the same period in 1992.

The $350 million World Bank loan will be disbursed over four years. The balance of the project costs, of $420 million, will be funded through federal and state grants and internal cash-generation by the water utilities. The first water supply and sanitation loan, of $300 million, was approved in December 1990 and is almost fully disbursed.

Solid Waste

The Second Solid Waste Management project, assisted by a $200 million World Bank loan, supports an ambitious national program to modernize and improve solid-waste services for an estimated 11 million people in the 23 medium-sized cities expected to participate on a first-come, first-served basis.

The project will assist in the development of federal standards for solid-waste management, which currently do not exist. It will also increase the technical, administrative and regulatory capacity at the state and local levels to improve sector management and operations through a National Training Program and actions to strengthen environmental management and monitoring.

Collection, transfer and final disposal of solid waste are inadequate in most cities in Mexico. Waste generation is estimated at 0.7 kg/person/day resulting in more than 60,000 tons a day for the country, with Mexico City accounting for more than 13 percent of the total. Data collected in 1993 in five cities in the Northern border area (Tijuana, Torreon, Monclova, Matamoros and Reynosa) suggest an accelerated increase in solid-waste generation to about 0.9 kg/person/day in the last three years.

It is estimated that only 70 percent of solid waste in Mexico is collected. Collection is impeded by poor management, old and poorly maintained equipment fleets, and on-truck scavenging. Of total waste generated, it is estimated that only 15 percent is properly disposed of primarily because of poor management or the absence of sanitary landfills.

The main benefits of the project will be better collection practices, improved urban environmental quality, and replacement of open dumps with controlled sanitary landfills which will eliminate leachate contamination of surface and groundwater resources, reduced public health effects and control disposal of dangerous commercial and industrial wastes in municipal sanitary landfills.

Private sector participation, which is expected to help improve the efficiency of solid-waste service, will be encouraged and supported through the investments to be made, an improved regulatory framework, increased municipal experience with tariffs and concession agreements and the preparation and use of model bidding and contract documents.

Marginal urban areas would benefit through the extension of service to these areas which previously had not received service because of resource constraints which will be alleviated under the project.

One of the project's unique features is the incorporation of garbage scavengers -- one of the poorest and most vulnerable sectors of urban society, many of whom are women with children -- into the project. The project will help improve their living and working conditions while maintaining the benefits of extensive traditional recycling and employment opportunities in the face of modernization.

The social component for scavengers includes their resettlement from open dumps or inadequately maintained landfills which will be closed or rehabilitated under the project, investments for more organized recycling activities, and training for other types of work.

The project also includes specific studies on recycling and preparation of a national public awareness campaign which will result in the development of a national strategy for recycling.

The $200 million World Bank loan will be disbursed over five years. The balance of the project financing ($215.5 million) will be provided by the Government of Mexico and local government contributions. The first solid-waste management project was assisted by a $25 million loan approved by the Bank in March 1986.

The three World Bank loans were made to BANOBRAS, with the guarantee of the United Mexican States. They are for 15 years, including five years of grace, with a variable interest rate, currently at 7.27 percent, linked to the cost of the Bank's borrowings. They also carry an annual commitment charge of 0.25 percent on the undisbursed balances.

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BANK NEWS RELEASE NO. 94/76LAC

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WORLD BANK APPROVES $412 MILLION LOAN TO IMPROVE PRIMARY EDUCATION IN MEXICO'S POOREST STATES

WASHINGTON, March 31, 1994 -- The World Bank has approved a $412 million loan to Mexico to assist the government in improving the quality and efficiency of primary education in ten poorest states, benefitting approximately 1.5 million children.

With a total cost of $616.7 million, the second primary education project will help reduce education deficiencies in the states of Campeche, Durango, Guanajuato, Jalisco, Michoacan, Puebla, San Luis Potosi, Tabasco, Veracruz and Yucatan.

The project will also reinforce management capacity in four other poorest states (Chiapas, Oaxaca, Guerrero and Hidalgo), covered by an earlier project that is being assisted by a $250 million World Bank loan approved in September 1991.

The second primary education project will improve primary school students' academic achievement levels and reduce the high repetition and dropout rates. It will also contribute to raising the human capital level, redressing some of the country's social and economic imbalances as part of the government's social compensatory program.

The project will provide training and assistance to upgrade the skills of primary school teachers, principals and supervisors; educational materials, library and reference books, and bilingual textbooks and reading materials for indigenous schools.

Mexico has the largest indigenous population in Latin America, approximately 8.7 million, or 10.4 percent of total population. Indigenous schools suffer from the absence of appropriate textbooks and educational materials and 90 percent of indigenous teachers do not possess the officially required qualifications.

The project will devote $125 million, or over one fifth of total cost, to support the education of indigenous children by providing for teacher training and incentives, textbooks, didactic materials, and school construction, rehabilitation and maintenance.

NOTE: Money figures are expressed in U.S. dollar equivalents.

Textbooks and reading materials will be developed in the 17 main native languages spoken in the project areas: Chol, Chontal, Huasteco, Huichol, Maya, Mazahua, Mexicanero, Nahuatl, Purepecha, Tepehuano, Totonaco, three variants of Nahuatl, and one each of Huasteco, Maya, and Totonaco, covering about 90 percent of all ethnic groups in the project states.

The World Bank is the single most important source of external financing for the primary education sector in Mexico. In addition yo the first primary education project financed in September 1991, the World Bank has approved an $80 million loan in September 1992 to help finance an initial education project in ten of the poorest states.

By focusing on the poorest states, the current project will also complement a series of World Bank-financed projects aiming at poverty alleviation, covering the areas of basic health, low-income housing, technical training, decentralization and regional development, water supply and sanitation, and labor market and productivity enhancement.

In addition to 1.5 million children, the project will benefit 53,000 teachers and 1,140 administrators. Additional benefits are expected for women, particularly from the indigenous population, as research has demonstrated that increasing their level of education has a significant positive effect on the health status and educational attainment of their children and contributes to lower fertility.

The Government of Mexico will provide $204.7 million to cover the balance of project cost. The World Bank loan will be disbursed over six years, period of implementation of the project.

The $412 million World Bank loan was made to Nacional Financiera (NAFIN), with the guarantee of the United Mexican States. It is for 15 years, including five years of grace, with a variable interest rate, currently at 7.27 percent, linked to the cost of the Bank's borrowings. It also carries an annual commitment charge of 0.25 percent on the undisbursed balance.

THE MEXICAN PESO CRISIS

THURSDAY, MARCH 9, 1995

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:12 a.m., in room SD–G50 of the Dirksen Senate Office Building, Senator Alfonse M. D'Amato (Chairman of the Committee) presiding.

OPENING COMMENTS OF CHAIRMAN ALFONSE M. D'AMATO

The CHAIRMAN. The Committee will come to order. I would ask at this time, given our first panel of witnesses, that we withhold our opening statements. I know Senator Bennett will be somewhat delayed. He has an opening statement. I know all of the Members will but, given that we do have our colleagues and that they all have pressing engagements, I'm going to ask that we take them first and then, for any of the Members that want to make opening statements and I'm sure that most will, we'll return to opening statements.

Let me call upon Senator Murkowski, who told me he has a Committee briefing that he's chairing.

Senator Murkowski.

OPENING STATEMENT OF FRANK H. MURKOWSKI U.S. SENATOR FROM THE STATE OF ALASKA

Senator MURKOWSKI. Thank you very much, Mr. Chairman. I want to commend you for holding this hearing and for your leadership on this matter as we look at the Mexican assistance package.

I think it's fair to say that the peso investment crisis in Mexico, as we reflect on a timeframe, has been going on for over 3 months as a crisis and, in spite of our intentions, there doesn't seem to be much let-up in sight.

With each passing week, it appears that the Mexican economy and the stability are slipping further into the darkness, with virtually no end in sight.

I think it's fair to say, at least in my opinion, that the Clinton Administration has unilaterally decided approximately mid-December to place the financial resources of the U.S. Treasury behind the peso and the governing party in Mexico, the Institutional Revolutionary Party.

The fate of the U.S. dollar has become increasingly linked to the Mexican economy, which is a rather curious parallel.

I believe the Administration's prescription for bolstering the peso and Mexico's economy is both ill-conceived and short-sighted.

I think it's time for the Administration to consider—or reconsider, I should say—it's bailout plan from top to bottom, because it's simply not working. The sooner you recognize that, why, the less risk and commitment you have to make.

I think it's continuing to deteriorate and it continues to place undue pressure on the U.S. dollar as a consequence. We're all aware that the Administration did an end-run around Congress at the end of January when it decided to use the Exchange Stabilization Fund to bail out Mexico. The size of that bailout, Mr. Chairman, as you and I recall, was somewhere around $26 billion, then it got up to $42 billion and $46 billion and is now $52 billion.

We all are very much aware that the Administration tried to generate support in Congress. It wasn't there, so they came up with the funds.

Despite our efforts to stabilize the peso, it has continued to slide down today by nearly 50 percent and because of the Draconian economic austerity, which was laid down by the U.S. side and the International Monetary Fund, the Mexican stock market has dropped to levels not seen in an extended timeframe.

Mr. Chairman, there is no investor confidence in Mexico today. Inflation and interest rates have simply exploded. Yields on 28-day Mexican treasury bills hit yesterday was 53 percent. Today, it's 58 percent. The centerpiece of the U.S. bailout plan, refinancing the dollar index bonds known as the Tesobonos, is not working, either.

Just this week, the government sought to roll over a $490 million issue that matures this week, although the central bank hoped to sell $100 million of new Tesobonos, bids totaled a mere $36 million. So they can't even sell it at those interest rates.

Now, consider the risk you have to pay to offer that kind of a rate, and you can still only sell, approximately, just a third.

So what happens to the holders of the $490 million in Tesobonos when almost no one is willing to roll over the debt? That's what we feared.

We were told by the Administration, the Secretary of Treasury, don't worry. Once the commitment is made, they'll roll over the debt. Others suggested they'd run—when the bonds became due, get their money and go some place else.

I think it's a self-fulfilled prophecy. The Mexican government is using funds secured by the U.S. Government to pay off its bondholders. It's just that simple. The investors are immediately converting the pesos into dollars and taking the proceeds out of Mexico. And some of them are surely converting their dollars into—what?—yen and marks, because they know that America has tied its economic fate to bailing out Mexico, or at least a good portion of it, in my opinion.

Mr. Chairman, in January, the Mexican government committed to an economic program that assumed an inflation rate of 19 percent and a GDP growth of 1.5 percent this year. With interest rates at over 50 percent today, and indexed mortgage loans in the 70 percentile, with inflation absolutely out of control, that plan has long ago been scrapped.

The Mexican government has not come forward with a new plan. If you look at the headline today, the Wall Street Journal, which

I would offer as evidence, March 9, 1995, it says, "Peso Hits New Low As Mexico Delays Its Economic Plan."

I don't know if Mexico's economic plan is going to be the answer but, certainly, the status quo hasn't been the answer, and we've been waiting for their economic plan.

The economic terms the United States and the IMF have imposed on Mexico could lead, in my opinion, to continued decline, a real depression in Mexico, on top of the political chaos surrounding the PRI.

It is not unrealistic to expect the international investment community to be extremely reluctant to invest new funds in Mexico in the foreseeable future.

So what should the United States do?

I think the real issue, now that we're 3 months into this crisis, is what should the U.S. Government do? Should we allow the U.S. Government to use up more than half of its resources in the ESF in a futile effort to bail out some of the foreign investors, foreign investors who speculated on Mexican debt?

They speculated on that debt because they were aware of the prospects of a high return and they should be subject to the risks associated when that return goes sour, and that's just what's happened.

It's estimated that $53 billion would now not be enough to do the job. How much will? We don't know. Mexico knows that our Treasury Department ought to know because all of Mexico's dollar-denominated debt is estimated to be worth about $80 billion.

So, Mr. Chairman, if we think back, and history teaches us—some people say not much—Bill Seidman, former Chairman of the FDIC, I think had it right when he suggested that the creditors of Mexico ought to sit down and work out a repayment schedule with the government. I was a banker for 25 years, and I see my colleague, Connie Mack, also. It's done every day. It's the only solution. When you've got a bad deal, you sit down and work it out. That's the bottom line. It works because it's the system working.

If you can get a bailout from the Federal Government, or a guarantee, you're going to run with it. That's what happened.

The United States should not put up any further taxpayers' resources to pay off these debts. The economic austerity conditions we've mandated will ensure severe economic dislocation in Mexico and will not, I believe, save Mexico from its debt crisis. This has to be worked out between the Mexican government, its banks, its foreign creditors, and the holders of the debt.

I have no doubt that this will mean real pain for Mexico, but it has to be done. The bailout crafted by the United States ensures a real pain for the people of Mexico, economic recession or worse for Mexico, and it's almost guaranteed that the U.S. balance of payments deficit with Mexico will increase for years to come. The only winners will be the foreign speculators and the Mexican debt.

So, Mr. Chairman, I think it's most appropriate that you have continued to pursue this matter because I know it's a little like rowing uphill—you're not getting a lot of support from the Administration.

The CHAIRMAN. That's an understatement. I thank the Senator. Senator Brown.

OPENING STATEMENT OF HANK BROWN U.S. SENATOR FROM THE STATE OF COLORADO

Senator BROWN. Thank you, Mr. Chairman. I want to be very brief, but I want to state three things succinctly.

One, I support your bill and I'm proud to cosponsor it. Putting a limit on this disaster, I think, is essential in at least having some congressional input before over $5 billion is spent as a minimum mark. I'm proud to join you and I commend the Chairman for doing that.

The second point I want to make is this.

A lot of us in America thought that if we would come to the aid of Mexico, it would win us friends.

If you look at the basic reason we got involved in this, it came down to the President and others thinking that if we helped the Mexicans out in a time of need as a banker, if we lent them money to get out of the crisis, they would end up liking Americans and liking us, and it would build a stronger relationship.

Mr. Chairman, I mentioned at the time, and I mention now, that is simply flat not true.

Let me read to you the Mexican press and the papers, and I won't take long, but there's just some synopses that I hope the Committee will think about as we go forward.

From Reforma and El Norte:

> Seventy-four percent of the population of Mexico City wants the Mexican government to turn down the $40 billion worth of loan guarantees the United States is offering.
>
> In Mexico City, 78 percent of the respondents and in Monterey 64 percent distrust the President's pledges not to accept any conditions that would undermine the national sovereignty in exchange for guarantees.

As I know the Committee knows, at the time our Administration was promising there would be conditions, the Mexican President was indicating that he wouldn't accept any conditions that undermine the sovereignty of the country.

The next source is from the International Herald Tribune. The headline reads, "Mexicans Deplore Loss of Sovereignty in the Loan Package."

The article states the United States–Mexico agreement could "tarnish Washington in the Mexicans' eyes by portraying it as an economic bully."

The third source is from an article in the U.S. News and World Report. This is in March. "A cure worse than the disease? Opposition to the U.S. rescue package in Mexico."

> At a protest in front of the Mexico Central Bank, Mexicans chanted, 'No, to usury.'
>
> Alphonse Ramirez, the organizer of the Central Bank protest, shouted, 'Why should we pay foreigners high interest rates?'

Mr. Chairman, those who thought that becoming the banker for Mexico and imposing financial discipline on Mexico from the outside was a way to win friends from the United States simply didn't know what they were talking about. It's time for us to understand that and to recognize the mistake.

Mr. Chairman, the third thought I want to leave with you, if I can, is to ask you to look at this chart.

You can look on the chart, where the yen and the dollar and the mark and the dollar were when the Mexican bailout was announced, and what happened after the announcement.

The result is graphic and it is obvious. Tying the U.S. dollar to the Mexican currency harmed the dollar. It did not rescue the Mexican currency. It did not rescue the peso. What it did was help destroy the credibility of the dollar.

The next factor, which is of major importance and I think has an enormous impact on it, is when the Balanced Budget Amendment failed. With the championing of the President to the opposition to it, the dollar fell to pieces.

Sometimes we don't read foreign press, but sometimes they speak for a lot of people. Here are a couple of quotes that say it fairly clearly, although it is difficult for any of us to look at.

This is from the Frankfurt paper.

> America, the biggest international creditor after the war, has become the biggest debtor. No other country but the major political power and economic power of the world could have afforded to pursue this financial policy for a long period of time.
>
> But he who incurs debts abroad makes himself dependent on the disposition of foreign investors.

Mr. Chairman, that's what this country has done. We've made ourselves dependent on the disposition of foreign investors. Until this country gets our act together, until we're willing to pass the Balanced Budget Amendment, until we're willing to end some of the waste in our own home town, the crisis that has affected Mexico is going to affect the United States.

The CHAIRMAN. I thank the Senator for his observation and I would note for the record that he has cautioned, on a number of occasions, that we would be viewed as the ugly American if, indeed, this went through, if the conditions that have been imposed and are being imposed were to take place.

This, unfortunately, is coming to pass.

Congressman LaFalce.

OPENING STATEMENT OF JOHN J. LaFALCE U.S. REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Representative LAFALCE. Thank you very much, Mr. Chairman. I ask unanimous consent to put the entire text of my statement into the record and to abbreviate it.

The CHAIRMAN. So ordered.

Representative LAFALCE. Thank you.

This morning, I'd like to make the following major points which embody some of the lessons I believe we should take away from this experience.

First, the United States should never again enter into a free trade agreement without appropriate currency provisions.

Second, we must give as much attention to the rights of labor as to the rights of capital in negotiating international trade agreements.

Third, the United States intervention policy in situations like Mexico must be guided by predetermined criteria and standards that minimize ad hoc decisionmaking based on political and other circumstances.

Fourth, we should reassess the conditions of our participation in NAFTA, reevaluate our initial assumptions about the underlying soundness of the Mexican economy, and reconsider the North American currency arrangements.

Let me take those points individually.

Changes in currency relationships have a dramatic impact on trade relations that cannot be ignored in formulating trade agreements.

We've seen substantial volatility in international currency markets in the last decade. Going back to February 1995, the yen was trading, I believe, at 263 to the dollar. This week, it hit an all-time low, trading for a short period of time under 90 yen to the dollar.

In 1988, when the United States–Canadian Free Trade Agreement was signed, the Canadian dollar equaled approximately 90 American cents. Now, it's trading around 70 American cents.

In November 1993, when we approved NAFTA, the peso was approximately 3.5 to the dollar. Now, it's approximately 7 to the dollar.

The European currencies also have experienced substantial volatility. In the fall of 1992, three currencies withdrew from the EMS and speculative pressures continue on the pound, the lira, the peseta, et cetera, et cetera.

This volatility has profound impact on international trade and, if we are to avoid future problems like the ones we face today, we cannot enter into free trade agreements without currency exchange provisions.

Moreover, once we have entered into an agreement, absent such currency provisions but based upon certain underlying assumptions, we cannot allow the free trade agreement to remain fixed in stone in the face of those substantial changes which call into question some of the agreement's most fundamental premises.

As you will recall, supporters of NAFTA widely advertised the U.S. export gain and job creation that would result from NAFTA.

The core assumption, always implicit rather than explicit of the econometric models projecting such gains, was that the peso-dollar relationship would remain stable at about 3.5 to 1.

The fundamental premises are no longer operative. Therefore, the gains proponents cited must now prove illusory. So we must consider immediately two subsequent supplemental amendments to NAFTA.

First, a corrective mechanism which can adapt NAFTA to the new economic assumptions that we must deal with. I call upon the USTRA and the Treasury to meet with Canadian and Mexican counterparts to consider and discuss this issue.

Second, it is late. It is very late. But if NAFTA is to continue, we must also have a subsequent supplemental agreement with respect to our currencies. It's imperative.

I would also, Mr. Chairman, like to put into the record some letters that I've sent in the past, in 1993, to Administration officials and others with respect to the potential peso-dollar difficulties we might experience and their responses to me in 1993.

Beyond the agreements we have, there is a real question as to whether we can have totally free-floating currencies in today's interdependent global economy, made more interdependent by com-

munications technology that allows instantaneous currency transactions.

Whenever we've had a union in the past, a fundamental premise of it has been a single currency.

Take the United States. We formed, when we adopted the Constitution, not only a political union, but an economic union. We adopted an interstate commerce clause. The premise of that interstate commerce clause is that a dollar in New York would be the same as a dollar in Pennsylvania, as a dollar in Georgia, as a dollar in Virginia, et cetera.

When the European union was formed, it at least contemplated working toward a single currency as the sine qua non of its effort to achieve true economic union. The absence of such a currency has posed serious problems for them. At least they do have the ecu when it comes to trade transactions.

We have a very important meeting coming up in Halifax. I believe it is in June. Some individuals have talked about what the subjects of that should be. There should be one subject, and that is exchange rates globally.

We need to do a number of things.

No. 1, we need to have, clearly, an early warning system, much better than what we have today.

No. 2, we need to have some corrective mechanism, perhaps through the auspices of the IMF, to deal with sudden, unforeseen problems, such as the devaluation of the Mexican peso.

Most importantly, we must have a provision dealing for orderly arrangements amongst the different currencies themselves.

There are a number of options. I won't explore them all or comment on them all. Some would say, "Well, let's return to the gold standard." I don't embrace. I do not rule it out any longer, however.

Some would say, "Well, we ought to have a fixed band in which the currencies must operate, and perhaps that's the approach we should take."

Clearly, our present system doesn't work. It's broke. It needs fixing. These three issues should be the total agenda of the Halifax meeting. Perhaps they can work together to give some legislative guidance to the approaches they should take.

Now, let me comment, too, about trade agreements.

In the past, our trade agreements have dealt exclusively with the rights of capital. It is appropriate that we deal with the rights of capital. We have, today, global capitalism. There is no longer New York capitalism, Florida capitalism, North Carolina capitalism, Utah capitalism, or United States capitalism. It is global capitalism.

We have transnational corporations, but we cannot deal only with the rights of global capital. We must also deal with the rights of labor.

Now, I know this is a wedge between our two parties, but it ought not to be.

Senator D'Amato, you have shown tremendous prescience on a good many of these issues. Maybe that's because we've agreed on a number of them. You opposed NAFTA and favored GATT, as did I. You've also been open to the perspective of labor.

We either will bring the standard of living of workers abroad up, or free trade agreements and increasing globalization of our economy will bring our standards down. We ought to enter into trade agreements that deal with those issues.

We talked about the devaluation of the peso and how it's going to affect exports, imports—all very, very important—but we often leave out the human equation, how it's going to affect people. There's a big difference to the Mexican worker when it's 7 pesos to the dollar as opposed to 3.5.

That means their standard of living has been cut in half in just a few months. That means they can buy half of the American goods they used to buy, which affects our workers in Buffalo, New York, Rochester, New York, New York City, et cetera, in addition to unbelievably impacting their standard of living. So let us not have a trade agreement in the future that doesn't deal with both.

Also, my third point, before we embark on a situation, we ought to have in mind what our criteria, what our standards are going to be for our involvement.

I am fearful that, in this Mexican situation, we jumped in, initially with the $40 billion loan guarantee and then with utilization of the Exchange Stabilization Fund, without any clear, predetermined criteria.

Some people said we must restore confidence in Mexico. That was foolhardy. We cannot restore confidence in Mexico. We can substitute confidence in the United States for confidence in Mexico, but only Mexico can restore confidence in Mexico.

If we're trying to simply assist them in the rearrangement of their debt, I think that would be very, very unwise.

If, on the other hand, we are trying to assist them in their predetermined policy to revalue their peso, that is something else again. I surely would not rule out United States' assistance to help the Mexicans on a steadfast policy determined to revalue their peso, but I'm not clear in my mind exactly what the United States' policy is in this respect, nor am I clear what Mexican policy is, nor of their ability to remain steadfast in that policy.

Just a few other points, Mr. Chairman.

We talk a lot about privatization now and that one of the things that Mexico and other countries have to do is embark upon privatization.

I think that's sound. I think we've seen tremendous privatization take place across the globe and we have been missing a golden opportunity, the opportunity to help facilitate a much more equitable distribution of the existing and potential wealth of society through privatization efforts, as has been done in some countries such as the Czech republic.

Instead, what we have witnessed in Russia, for example, is nomenclature of privatization. What we have witnessed in Mexico is petrome privatization, where the rich have become fewer and much, much richer but the masses have not benefited nearly as much as they could have if the United States had a very, very strong policy with respect to equitable privatization, which I would define as, or term, empowerment privatization.

Let us use this phenomenon of privatization to empower the people of the lesser developed countries.

My last point—two last points.

Let's not forget the quiet crisis to the north, Canada. It's gone from almost 90 American cents on the dollar to 70 cents. It could go much further south, and Canada is our largest trading partner. Let's deal with that before it becomes a problem, rather than after, by having close consultation and cooperation in decisionmaking with Canada.

Finally, in 1988—you know I've been interested in this for a long time—I authored legislation, which I was able to get into the Omnibus Trade Bill, which said that exchange rates are so important to international trade that, at the very least—we tried to give them guidance as to the type of policy they should follow. We also said that Treasury must submit reports every 6 months on currency exchange rates around the globe, on what's going on, and that we should monitor that.

As Chairman of the Small Business Committee from 1987 on, I had hearings on each and every report. This last report was dated December 1994, embargoed for release January 3, 1995, and I regret very much to say there's not one word of discussion of the Mexican peso or Canadian dollar.

There clearly should have been.

This is a subject, Mr. Chairman, for further hearing by your Committee.

I thank you very much.

The CHAIRMAN. Let me thank the Congressman. Let me also acknowledge for the record that the Congressman has been asking the important kinds of questions as it relates to how did this situation take place. He's asked for the kinds of documents that, to date, we have not been able to get.

Considering the magnitude of the investment of American dollars in this project, whether we agree with it or not, certainly we want it to be successful but, at the very least, we have a right to know.

I want to publicly commend the Congressman. It takes a great deal of courage when it is an Administration of one's party that one asks some of the difficult questions about.

So, let me publicly commend you, Congressman.

Congressman Istook.

OPENING STATEMENT OF ERNEST J. ISTOOK, JR. U.S. REPRESENTATIVE IN CONGRESS FROM THE STATE OF OKLAHOMA

Representative ISTOOK. Thank you, Mr. Chairman.

Mr. Chairman, I find it interesting listening to Congressman LaFalce. He mentioned he was against NAFTA and in favor of GATT.

I was in favor of NAFTA and against GATT. I think it shows the common elements that come together, though, with the concern about the Mexico bailout, that people who otherwise may disagree on some fundamentals have common and very serious concerns on this.

Mr. Chairman, I would like to focus in my comments not on the advisability of whether we should have entered into an agreement with Mexico of the transaction itself, but what it has shown us regarding the underlying secrecy at the Treasury Department regarding the handling of this massive Exchange Stabilization Fund and

the proper role that Congress needs to take both in looking at what we can still do on the Mexican bailout issue, what we can learn, and how we might need to change the structure of the fund and of our oversight role.

Of course, this fund is gigantic. If it is not needed for its major purpose of stabilizing the United States dollar, then why do we retain such huge amounts in it, subject to the supervision by statute solely of the U.S. Treasurer, who has one-man authority over it, subject only to the President of the United States?

If these funds are not needed to stabilize the dollar, then certainly they are needed, whether it be for appropriation by this body or to apply against the national debt, and should not be used as a slush fund by any Administration, whether it be to assist Mexico or for any other purpose.

Now, we all know that with its policy, the Administration is seeking the end-run around Congress. The fund with which they are acting is established under Title 31, Section 5302 of United States laws.

It's important to note that, by statute, and these are the words of the statute:

> Subject to approval by the President, the fund is under the exclusive control of the Secretary and may not be used in a way that direct control and custody pass from the President and the Secretary. Decisions of the Secretary are final and may not be reviewed by another officer or employee of the Government.

This is a very unusual statute, as we both know, especially considering the constitutional role that we play as Members of Congress in oversight of this fund and in oversight of appropriations.

The Administration has not kept us fully informed, of course, of the details of this. Last week, the House was compelled to pass a resolution of inquiry to ask the Treasury Department to further information to us that they have not been willing to provide previously regarding the details of the transaction and the fund.

I would especially like to note, Mr. Chairman, that by law, the Secretary of the Treasury is required to submit a monthly report to the House and the Senate through the respective Banking Committees of each body, and the statute specifies that the report will be a detailed financial statement on the Exchange Stabilization Fund showing all agreements made or renewed, all transactions occurring during the month, and all projected liabilities.

When I sought to see those reports, Mr. Chairman, I found something very astonishing to me.

First and foremost, if you look at the figures that they use in the fund, there is a major discrepancy between what they report in these private reports to Congress and what they say to members of the public.

These monthly reports to Members of Congress are classified by the Treasury Department as confidential. So, according to them, they cannot be shared with the media or with the general public under penalty of law.

They consider them to be secret documents.

If you look, Mr. Chairman, at the document that was submitted to you as a Member of the Banking Committee, showing the balances in the fund as of September 30, 1994, the close of the fiscal year, and if you compare that with the information that was pub-

lished about the balances in the fund on the very identical date, September 30, 1994, according to the public document, which was the Clinton budget which has an accounting of the assets of that fund in it, there is a $4½ billion discrepancy between what they report as the assets and liabilities of the fund in a confidential document and what they have reported to the public via the budget.

I inquired on February 14, 1995, to Secretary Rubin about what is the difference, what is the discrepancy?

To date, I have only received a letter, which I received on or about February 23, 1995, saying, "Well, we think it may be the difference between cash and accrual accounting, but we don't know yet, and we're reserving judgment and still looking at it."

According to the confidential documents, the balance in the fund as of the close of the fiscal year was $37.9 billion. According to what they reported to the public in the Clinton budget, the balance was only $33.6 billion, approximately a $4½ billion difference.

We still don't know the reason for that, and I cannot conceive of why they would need two sets of books, one to make confidential reports, and the second to make reports to members of the public, why they would need inconsistent accounting methods, if, indeed, that is the difference, and what else does that say about the manner in which the fund is being handled?

In addition, Mr. Chairman, the statute specifies that all transactions occurring during the month are to be reported to Congress in the following month.

If you examine the reports that have been submitted by the Secretary of the Treasury, and this practice did not begin with the current Administration, but if you examine those reports, you find that they give a balance sheet. They give an overview of the assets, they give an overview of the liabilities, but they totally omit any report of what transactions have been conducted by the fund.

That is a glaring discrepancy. Again, both on February 14 and on February 23, I personally questioned Secretary Rubin in Appropriations Committee hearings about that.

On February 23, I asked him directly, "Are you declining to provide to me or to other Members of Congress the specifics on the actual transactions that occur monthly with that fund?"

Secretary Rubin responded, "It is our view that providing specific transactions could be against public interest."

I was asking him about disclosure to Members of Congress, as required by law. He said he thought that would be against the public interest. He elaborated, "Because foreign exchange traders try to figure out how you are functioning and try to take advantage of it."

Now, Mr. Chairman, a fund of this magnitude, with assets generally in the range of $35 to $40 billion, should not be under one-man control. It should be totally reported. It should be totally accountable, not only to the public, but, in more particular detail, to Members of this body, the Senate, and, of course, to the House.

The CHAIRMAN. Congressman, let me ask you at this point, and I don't mean to open this up to—I want you to finish, and I want Congressman Flake to read his statement and make his observations, which I think are quite important.

It seems, from what you have indicated to us, that there is no problem with the law, that the law quite specifically calls for the kinds of information that Congress, at the very least, has a right to have.

Representative ISTOOK. Exactly right.

The CHAIRMAN. But there is a problem with the Administration complying with those requirements. Is that——

Representative ISTOOK. That is totally correct.

The CHAIRMAN. OK. In other words, we're not suggesting that it's inadequate as it relates to its reporting methods. You are suggesting that that which is called for under the law is not being followed through.

Representative ISTOOK. They are failing to follow the law and, when it comes to information requests from Members of Congress, they are stonewalling.

I attempted to discuss that with Secretary Rubin, and he said, "Well, we're willing to discuss it." But he wasn't even willing to discuss it in that meeting.

It's my understanding that they still haven't discussed it with respect to the Banking Committees. That rather than following the law——

The CHAIRMAN. By the way, that section does not say—there is no limiting. It does not appear, by reading of the statute, that there's anything that even limits it to what is public and what is private.

Representative ISTOOK. I totally agree. The statute does not create any privacy.

The CHAIRMAN. That's an interpretation they have added to it.

Representative ISTOOK. Correct. Correct.

The CHAIRMAN. OK.

Representative ISTOOK. A fund of this magnitude, as you and I both know, Mr. Chairman, has the potential, and I'm not necessarily saying that it occurs, but it has the potential, of course, for tremendous abuse.

Also, in questioning Secretary Rubin, I established that there are some occasions in which the fund may conduct transactions using private brokers. It may generate fees or commissions for those. Again, that is a proper subject of oversight by Congress, who potentially has any benefits from the utilization of the fund.

Mr. Chairman, I would urge you, in the strongest possible terms, to insist that the Secretary of the Treasury and his subordinates totally disclose to all Members of the House and Senate the entirety of the transactions and the details of what was done, when it was done, how it was done, through whom it was done, and what expenses were generated in the process of these transactions of the Exchange Stabilization Fund.

I believe, Mr. Chairman, there is urgency in getting that information.

The Administration has been moving on a fast track, when it comes to the Mexico agreement, and they are seeking to be the hare and require us to be the tortoise. They have the inside information which they are not willing to share with Members of Congress so that we may properly conduct the oversight.

Of course, that begs the question of what else might we need to do to control the fund?

I'm aware of the legislation, of course, that you intend to introduce to limit disbursements from the fund. I think that is good legislation which I support and have asked to co-author.

In addition to that, I think, Mr. Chairman, that we may need to reexamine how much one-man control is necessary and under what restrictions might we need to place that in terms of the duration of agreements that are entered into. The Mexico agreement is 10 years. Previous transactions from this fund generally have not exceeded more than 1 or 2 months, at the most. It's been unusual to have a transaction that even entered into a 6-month or a 1-year period.

It's unprecedented to take over half of the assets of the fund and commit them to Mexico, or to any other nation.

Mr. Chairman, I would also ask, in understanding how much authority over a mega-billion-dollar fund is entrusted to the Secretary of the Treasury, that you examine the underlying agreements which we had great difficulty getting, even in full copies of the agreements, from the Treasury. If you examine the underlying agreements, you will also find that the collateral which is pledged to the United States, under this agreement, being the export proceeds for exported oil and gas from Mexico.

However, there is a clause in what's called the oil proceeds facility agreement, one of the subagreements. In paragraph 12(a)(3), it specifies that the Secretary of the Treasury has the ability to exclude some exported products from the collateral. So, if the same person that has one-man control of the fund decides to let Mexico off the hook and say some of your proceeds do not have to be put into this collateral fund, he can do so.

Again, that bypasses oversight of this body.

Not only that, but under 17(a) of the agreement, the Secretary, through the Treasury, has the ability to let that collateral be pledged to assist other banks, other nations, or other lenders to Mexico, rather than having that collateral serve as the security for the $20 billion which is sought to be advanced to Mexico under this agreement.

We have serious issues regarding the setup of this fund, the oversight of this fund.

To me, Mr. Chairman, and I will not pursue it in this hearing, but I think it requires a great amount of scrutiny regarding the personal and business relationships of any person that supervises that.

I have information on that, that I will give separately to you and Members of the Committee, rather than doing it in testimony.

Senator SARBANES. What is the Congressman suggesting by that comment?

Representative ISTOOK. I am suggesting only, Senator, that when you have someone who has changed the intended way that the agreement was handled—Mexico One sought to have the consent of Members of this Congress to the bailout agreement. Mexico Two changed it, where Mexico Two is under the direct supervision of the Secretary of the Treasury, who is the approving person.

When you change it from saying this is a consensus of a constitutional body to saying that one man is to make the decision, then I think you must scrupulously examine the history and the conflicts of interest that person may have.

You and I, Senator, when we have any transaction involving this body, of maybe only a few million dollars, find that the media, of course, scrutinizes what is the history of our relationship with anyone else that might be involved in this transaction?

I think when you have something of this magnitude, of a Secretary of the Treasury who previously had the government of Mexico as his client, that raises serious conflict of interest issues.

Senator SARBANES. I disagree strongly with you and I think it's an outrage for you to come trotting over here to make these kinds of allegations in front of the Committee, Mr. Chairman.

Representative ISTOOK. You requested me——

Senator SARBANES. The fact of the matter is that we went to the Exchange Stabilization Fund because the leaders of Congress and Members of Congress didn't want to take up and confront the first approach.

In fact, the leaders of Congress endorsed the use of the Exchange Stabilization Fund in a very explicit statement in that regard on January 31, 1995, both Republican and Democratic leaders, including Senator Dole and Speaker Gingrich. So the shift in approach is essentially congressionally-instigated.

For you to take that and then, in effect, come in here today and try to cast these aspersions—I'm happy to sit here and receive this testimony about the workings of the fund and questions you want to raise about how it's used, but I'm not happy to sit here and have you start pillorying people in a personal way without any basis on which to do it.

Representative ISTOOK. Senator, may I respond?

Senator, you elicited my comments regarding the Secretary.

Senator SARBANES. No, I addressed an innuendo that you threw out and wanted to simply leave hanging there. I wasn't about to have that happen.

Now, you can't walk over here, sit down at that table, start trashing people, and expect that you're going to be able to simply get away with that. It's outrageous.

If you want to be serious about questioning the Exchange Stabilization Fund and its use, I'm happy to address that in the course of this hearing. But if you're going to start trashing people, individually, with no basis, that's another situation. You're telling me you want to hang the shift in approach on the Secretary when it's very clear that the shift in approach was, essentially, congressionally-originated and encouraged.

Representative ISTOOK. Senator, if I may complete my response that I was attempting to give to you.

Senator, the shift in approach which you attempt to say was congressionally-initiated, I believe, is contrary to the reports of the Administration being the one that initiated the request to bail out Mexico and realizing that the rank and file, the vast majority of Members of the House and Senate, appeared opposed to it, the Administration made the decision to change.

As you, of course, will recognize, the fact that some Members of this body, your body and our body, may agree with the decision and that they may be in a leadership role, is not a vote either of the House or of the Senate.

If our votes were not needed, Senator, I suggest you and I would not be here.

When you refer to a lack of documentation, I would certainly encourage you, Senator, to do what I have done, which is to examine the disclosure forms that have been filed with the Office of Government Ethics by the Secretary, which includes a list of the clients with whom he, by his own terminology, had significant contact in his previous work, and you will find that, among other Mexican entities, listed on his list is the government of Mexico.

Senator SARBANES. Mr. Chairman, I would just put in the record a quote by Speaker Gingrich which appeared in the New York Times on February 2, 1995.

The President's action was defended by an unlikely ally, Newt Gingrich, the Speaker of the Republican-controlled House of Representatives.

'The President exercised his authority,' Mr. Gingrich said today. 'He took a tremendous burden on his shoulders. He did what key leaders felt was necessary.'

The CHAIRMAN. So ordered. It will be put into the record.

Representative LAFALCE. May I make——

Representative ISTOOK. If I may conclude my statement, Mr. Chairman.

The CHAIRMAN. Yes, Congressman.

Representative ISTOOK. Thank you. Mr. Chairman, in conclusion, I would certainly hope that in the Senate, as well as in the House, not only will we look at the legislation which you are offering limiting the disbursements from the fund, but also look at the underlying fund itself, how much of the assets are necessary to preserve the stability of the dollar? What sort of control over that fund is also necessary? What limitations are needed in the duration of any agreements and the amounts of any disbursements? And, certainly, if there is any necessary strengthening of what you and I seem to agree is a very clear reporting requirement, that, if it is necessary, it be pursued. Finally, of course, that all Members of both houses actually look at the history of the transactions of the fund itself so that we may exercise our proper oversight role.

I thank you, Mr. Chairman.

The CHAIRMAN. Congressman, thank you.

Representative LAFALCE. Mr. Chairman?

The CHAIRMAN. Congressman LaFalce.

Representative LAFALCE. Ten seconds.

The CHAIRMAN. Go ahead.

Representative LAFALCE. I simply wish to associate myself with the remarks of Senator Sarbanes.

The CHAIRMAN. OK. Congressman Flake.

OPENING STATEMENT OF FLOYD H. FLAKE U.S. REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Representative FLAKE. Thank you very much.

Mr. Chairman, Members of the Committee, thank you for allowing me the opportunity to testify before the Senate Committee on

Banking, Housing, and Urban Affairs. The crisis in Mexico and its related effects upon the Exchange Stabilization Fund have caused considerable controversy, and it is appropriate that Congress review the action taken by the Administration.

Because international financial markets react quickly and dramatically to any developments, I am supportive of the decisive action taken by the President. Yet, we in Congress have the responsibility to learn the facts of the current crisis and to take every opportunity to find prospective solutions.

I have concluded that, based on the current international climate, it is in our best interest to provide leadership in establishing a stable international financial market, especially for those markets and nations in close geographic proximity, and economic dependence.

Mr. Chairman, I testify today as an expert in community development and as Ranking Member on the Subcommittee on Domestic and International Finance within the Banking Committee of the House, with the clear understanding of the relationship between domestic and international policies.

Just as I believe that bold action using investment criteria provides stability in the international markets, the same effort must be made in the domestic arena.

I realize this is somewhat of a digression in the direction that this Committee has taken during the course of the day, with the total emphasis on Mexico. In this regard, however, I would argue that we cannot do one without looking at the other.

I suggest that our package to stabilize international markets within this country must also be reviewed while we continue our review of what is happening in Mexico. We must begin by bolstering the vulnerable parts of our domestic economy—the urban and rural communities which are, in effect, a Third World country within our own borders.

We must pursue programs like the Bank Enterprise Act, which builds upon public and private partnerships to provide needed investment capital, increasing the amount of programs, not from the traditional social arena, but understanding that we, as a Nation, must be prepared both to invest and to provide guarantees as we do for countries abroad.

If we can declare Mexico an emergency, then I would submit that this country must understand that it has its own emergency.

Mr. Chairman, let me explain my understanding of the United States–Mexican deal. As you most certainly are aware, the United States and Mexico have signed agreements implementing a $20 billion support package from the Exchange Stabilization Fund. Ostensibly, this package is intended to protect American jobs, exports, immigration interests, and security concerns caused by Mexico's lack of liquidity.

In return, Mexico has committed itself to an economic program which it purports it will follow in order to restore financial stability. The United States effort, through the Exchange Stabilization Fund, is expected to bolster that effort, by allowing Mexico to meet short-term debt. Finally, the proposed safeguards include notification, evaluation procedures, and the use of crude oil to secure repayment as a part of this process.

By using the crude oil to secure repayment, we, in effect, have determined that this is an appropriate collateral. However, I think all of us realize that that collateral is only effective to the degree that we have a government that understands and is prepared to honor this commitment.

I would also argue, as I have been in the position of trying to declare using funds in this domestic arena, that if we look very closely at opportunities that are available within our borders, we will discover that there are collateral sources in communities like those that I serve and have been instrumental in rebuilding. If we participated in the same manner, we would have the opportunity to stabilize our own economy.

Senators, I am not here today to specifically criticize the Clinton Administration's proposal. I, like many other Democrats and Republicans, concur with the President in his belief that the Mexican economic crisis is of grave concern to the U.S. economy.

This has been proven by the reaction of the dollar to changes that have taken place over the last several months.

However, I have come to realize that, while so many people have voiced complaints in spite of their sympathy for the Mexican dilemma, they have stated, quite correctly, that there are many problems in America that also need to be resolved. Therefore, it is my hope that, as we have been able to come together today for the purpose of addressing the peso problem in Mexico, we might also do the same as we look at the many problems which are endemic to communities here in America, where our own citizens are concerned about how they might be able to acquire the pennies necessary to meet their basic human needs.

I would also suggest, Mr. Chairman, that the average American citizen does not understand the issues of pesos, but they do understand falling dollars.

Mr. Chairman, I think as we discuss loan guarantees for Mexico, and as we look at avenues by which we might arrive at a resolution of our crises existing in our urban and rural communities, what I have named America's Third World, there is a necessity for us to also have the same kind of aggressive vigilance as we have to resolving and solve the problems that are here at home.

I think that most Americans are more than willing to support any program that strengthens a long-term international and domestic environment. However, like most Americans, I think that charity begins at home. Because of that simple credo, many of our citizens would be more comfortable in supporting the Mexican bailout coupled with a clear, bipartisan plan for economic development in our domestic arena.

I therefore believe that this international crisis and the resultant support system will provide the foundation for policies which will reverse the trend of poor quality education, rampant crime, and a crumbling infrastructure.

Mr. Chairman, I will close by stating that the best uses of our resources begin here at home, which means providing a level of stability for each and every citizen, so that they can understand that the responsibility of Government is to try to bring them the quality of life that is consistent with the rhetoric that we speak about democracy and move us to the point where, in fact, we have an all-

inclusive democracy. More importantly, even as we export that democracy abroad to Mexico and other struggling nations, we ought to do everything within our power to make sure that it is the essence of a quintessential nation in which all citizens feel a sense of inclusion.

Mr. Chairman, I hereby conclude my statement and ask and urge your support and the support of this Committee as we try to resolve all of our problems, both on the domestic and the international front.

Thank you, again, for the opportunity to share. Thank you, again, as my own Senator, for working consistently with me in trying to resolve the problems in both arenas.

Thank you very much, Mr. Chairman.

PREPARED STATEMENT OF CHAIRMAN ALFONSE M. D'AMATO

The CHAIRMAN. Thank you, Congressman.

Let me thank all of the Congressmen and ask, at this time, if any of the Members of the Committee have any additional questions they would like to put to the panel before we take opening statements.

[No response.]

Gentlemen, we thank you. We thank you for your candor. We thank you for coming forward.

This is the first of 2 days of hearings this week on the Mexican peso crisis. This Committee intends to hold further hearings in the coming weeks.

Yesterday, I received a letter from Secretary Rubin. Now, I understand the dollar is under assault and I believe that the American people have a right to know the full facts before more of our money is committed to Mexico.

The Secretary's letter seemed to be rather scolding in its tone, in nature, and it questioned the wisdom of Congress asking questions.

The Secretary, in effect, was asking Congress to be silent while the Treasury finalized its work—in secrecy, I might add.

This Senator will not be quiet. The American people have a right to know how much United States money has been committed to Mexico.

We keep hearing the Administration has committed $20 billion from our Exchange Stabilization Fund, but what about the $9 billion line of credit that the Administration established for Mexico as of January 2, 1995? Is this $9 billion on top of the $20 billion? Is it really $29 billion?

What about the untold billions and how much has been contributed to the IMF fund? Have we contributed $30 billion? Have we committed $40 billion? Exactly how much has been drawn down?

We were told that $3 billion was drawn down. Is that $3 billion from the Exchange Stabilization Fund? How much from the IMF fund? How much from the lines of credit which were already extended?

So, simply, we're saying that the American taxpayers have a right to know how much of their money is being sent and has been sent to Mexico.

Is it $20 billion, is it $30 billion, or is it $40 billion? I don't know, but, certainly, the people have a right to know and Congress has a right to know. I think that Congressman Istook clearly delineated the problems in terms of Congress getting the kind of information that the law clearly intended for us to have.

The people have a right to know how that money is being used in Mexico. Congress has a right to know—how is that money being used in Mexico? Is it being used to prop up Mexican banks? Is it being used to help pay off rather speculative bonds at very high interest rates? Are the Mexican banks continuing to print pesos right now, as we attempt, and some of us say to help stabilize the Mexican economy, to keep the peso from going through the ceiling?

Again, Congress has a duty and the people have a right to know.

I believe the Administration has made a mistake in joining the fate of the American taxpayers to the fate of a corrupt, dictatorial Mexican regime. That is what the sad history of the PRI has been. That is fact.

It is a myth to suggest that they have a real democracy. We are kidding ourselves and we are joining in keeping this collusion going. It is not right and it is not proper for us to do so.

I believe it was wrong for the Administration to go around the will of the people's elected representatives. The Exchange Stabilization Fund is not the personal piggy bank of the Administration, and that's how it has been used. We stretch the imagination when we utilize it in the manner that has been done. It was never intended for that purpose.

When all is said and done, I predict that the Administration's bailout of Mexico will go down as one of the worst deals for the American taxpayers in our Nation's long history. I don't believe that the bailout can or will work in the present circumstances.

The Mexican people will blame us. They will blame us for the pain that is being inflicted upon them right now. They are doing it right now.

Imagine your mortgage rate going to 85 percent and hearing daily that this is a result of the economic conditions that were imposed. Imagine businessmen attempting to pay back their loans and not having the ability to do so as a result, again, of interest rates going, in some cases, from 20 percent to as high as 85 percent within a matter of months.

As I said yesterday, the time has come for Congress to stand up and fight for the American taxpayers, certainly to get the facts and information that we're entitled to.

I think we have an obligation to hold the Administration accountable for the actions they are undertaking.

Senator Sarbanes.

Senator SARBANES. Mr. Chairman, I'll defer my statement until the other colleagues have completed theirs.

The CHAIRMAN. Senator Faircloth.

OPENING STATEMENT OF SENATOR LAUCH FAIRCLOTH

Senator FAIRCLOTH. Mr. Chairman, I first want to thank you for holding this hearing and I totally and enthusiastically support the bill that's being proposed.

I oppose the bailout of Mexico One and Two. I don't think we should have been involved.

Six weeks ago I asked Alan Greenspan, "How did Mexico get into this situation? What is the United States doing differently from Mexico?"

He said, "They got into the situation because their domestic spending was out of control." He said, "Their trade deficit was out of control and they had excessive borrowing."

I asked him, "What did they do that we aren't doing in bigger figures?" He said, "Not anything."

There's one difference, a great big difference. That is—and they're doing it rapidly—when foreign exchange traders lose faith in the dollar, there's no one to bail us out. When we become the bailee instead of the bailor, we're going to sink.

A perfect example of what I'm talking about is the decline in the dollar. You can look at the chart that Senator Brown left. The dollar started declining against the mark, the yen, and most of the other industrialized currencies of the world as soon as we started fiddling with Mexico and talking about a bailout. The decline accelerated when we failed to pass the Balanced Budget Amendment.

I have the highest respect for the individual, but when Senator Hatfield, Chairman of the Senate Appropriations Committee, voted against the Balanced Budget Amendment, we sent a clear signal to the other countries of the world that we didn't intend to control spending and we intended to go on just like we had been going—no other message, no other interpretation, could have been received from the message.

The foreign exchange traders reacted immediately.

We will give Mexico, if we can ever get the figures right, $20 billion. It will not be paid back. The purpose of this fund was to stabilize our own currency.

I suspect that some day soon, and, certainly, the indications are real soon, we would need the money to bail out our own currency.

Where will we get the money? How much is it going to take to bail out Mexico?

I remember a short 10, 12 weeks ago, it was $12 billion. Then we went into any number of meetings and were told that we want $40 billion, we want Congress to approve $40 billion so that we will have a surplus, so there can be no question that there will be an enormous amount of money left over after Mexico is stabilized. That's the reason we're asking for $40 billion.

Now they say $52 billion and sinking. How much will it take and when will it stop?

Mr. Chairman, the Mexican economy has to be addressed by the Mexican people. As has been said here several times this morning, they already resent our interference. Nobody ever falls in love with his banker when he has to pay the bill.

We are talking about laying down rules and regulations to stabilize the Mexican government. We're talking about putting constraints on their spending. That is, the Congress of the United States is going to put constraints on Mexico, and for 30 years we have been spending totally out of control and aren't about to begin to control ourselves. We have been spending ours like it was confetti.

Mr. Chairman, I hope that with your bill and your influence Congress will stop immediately this ill-conceived attempt to bail out Mexico, find out how much has already been spent, and stop the spending and the facade that it has perpetrated upon the American people.

The CHAIRMAN. Thank you, Senator.

Senator Mack.

OPENING STATEMENT OF SENATOR CONNIE MACK

Senator MACK. Mr. Chairman, Mexico has a currency crisis and, to a lesser degree, so does the United States. Bad economic policies are at the root of both countries' currency problems.

Bailing out Mexico will only work if Mexico adopts sound economic principles and sticks to them.

Tax cuts, not increases, free markets, not wage and price controls, sound money, not runaway printing presses, and more privatization will get Mexico back on its feet.

These are the recommendations that will create jobs to employ the Mexican people. These are the recommendations that will establish and improve the standard of living for its citizens. These are the right recommendations.

I am concerned because these seem to be the opposite of what the Clinton Administration is recommending to Mexico. The IMF austerity measures adopted by the U.S. Treasury promote wage and price controls, tax increases, and further peso printing. These measures will lead to further decline in the demand for pesos and more capital flight.

Investors must be given incentives to invest. These incentives will only come with major changes in economic policy. This is true in both the United States and Mexico.

International investors watching the Clinton Administration give bad advice to Mexico and seeing the liberals in Congress defeat the Balanced Budget Amendment think that the United States is not serious about fiscal reform.

We cannot underestimate the seriousness of the dollar's plight. A weak and volatile currency undermines the economy, lowers the purchasing power of consumers, leads to inflation, and undermines the confidence of international investors.

Despite these historic truths, the Administration continues to cling to failed economic policies responsible for the falling dollar.

We have an historic opportunity to help people throughout North America, but we must lead the way. First, we must be more disciplined about our own reform, slashing Government spending, balancing the budget, and cutting taxes so that money can stay in the productive sector of the economy to be used for job creation and investment.

Second, we must give sound economic advice to Mexico. I've introduced legislation to ensure that we do. The Mexican Loan Compliance Resolution provides that Congress will be fully informed about the economic situation in Mexico and will be made aware of problems before they shock the world.

By strictly adhering to free market economic principles, we can prove to ourselves, to Mexico, and to the rest of the world that the

United States is serious about achieving long-term economic growth and stability.

Mr. Chairman, I was really interested in the comments earlier this morning from Congressman Flake, and had the opportunity to talk with Jesse Jackson about many of the same ideas.

A couple of thoughts occurred to me as I was listening to the Congressman and also considering the first time that I had traveled abroad and went from one country to another. I was struck that one could cross a line, an imaginary line, one that you couldn't even see was there, and on one side of the line people were prospering. People had better lives. They had a greater hope for the future.

On the other side of the line, people who looked the same, seemed to act the same, and I assume had the same degree of intelligence were living in poverty and weren't making things work. It just wasn't going their way.

I was wondering, how can that be? What caused that? When I was listening to Congressman Flake this morning, it dawned on me once again, it's the same thing. If you put the wrong policies in place, people are going to suffer.

What you have in America and, Mr. Chairman, in the so-called Third World in America, if you look at our urban centers, our inner cities, if you look at the kinds of policies that they have in place—higher taxes, more Government, increased regulation, more spending, price controls—what do you get? You get capital flight. You force people out of the market.

Investors don't want to invest in these markets. So what do you have? You have a city, a nation that is crumbling, that doesn't have the resources to invest in its people and its future.

I think this discussion is really important for people to understand that it really does make a difference what Mexico does with its economic policies and choices it makes, more than what the United States is going to do.

We can put all the money in the world down there, but if they don't have the right policies in place—and, as you can gather from my opening statement, to impose on Mexico these IMF policies, you're going to get capital flight and that's just the opposite of what I think they want to occur.

I thank you, Mr. Chairman.

The CHAIRMAN. I thank the Senator.

Senator Bennett.

OPENING STATEMENT OF SENATOR ROBERT F. BENNETT

Senator BENNETT. Thank you, Mr. Chairman. I've been taking careful notes and I'll try to summarize where I am based on what we've heard this morning.

First, let me make it very clear, I support you and your decision to hold these hearings. I think the airing of these issues in a formal forum is vital and overdue.

We've had too much debate in newspapers and informal forums and I think putting it into the context of a hearing before the Senate Banking Committee is exactly the right thing to do, and I congratulate you for your leadership on doing that.

I would like to make a personal comment about the exchange that took place earlier and bring it down, I think, to what people are saying.

During this whole circumstance, by virtue of a series of situations that have arisen, I happen to have found myself in conversation with Secretary Rubin fairly often, perhaps more often than he would have liked.

I found myself in disagreement with Secretary Rubin during some of those conversations and, while I won't say we got heated with each other, I got fairly strong in expressing my opinion on occasion.

Once, in an effort to convince the Secretary that I was right, I urged him to call his old friends on Wall Street. I even gave him some names and said, "Call these people. They will tell you that I'm right."

He said, "I won't do that, Senator. I won't call those people on Wall Street."

I think that, while I disagree with Secretary Rubin in a number of areas, I am willing to give him the benefit of the doubt in terms of any conflict of interest charges.

The CHAIRMAN. I might add, at this point, I agree with the Senator. I think I do believe that there is an accountability that we both want to see take place as it relates to the legislation, but, certainly, I think it's inappropriate to get on this area of conflict.

If we have a conflict, it may be in terms of ideas, in terms of how you carry out the program, whether we should be sending money down, as we have, and the manner in which we have but, certainly, not as it relates to what his past responsibilities were and what his new responsibilities are.

I'd just like to join you in making that clear.

Senator BENNETT. I thank you, Mr. Chairman, because I think we can muddy-up the disagreements we're going to have on policy if we go down the road of suggesting that——

The CHAIRMAN. Yes. If I might ask for your indulgence, this is a hearing to attempt to get all of the facts out on the table as they should be.

We're talking about substantial sums of money. We're talking about important policy. We're talking about whether the law is being implemented in the manner in which it was intended. We have a responsibility.

I thank the Senator because we do not want to muddy this up with other matters. I think Senator Sarbanes was correct in saying, let's put that and deal with that. It doesn't belong here. That's not what this hearing is intended to be about.

I just want to join with you in that.

Senator BENNETT. Now, the Mexican economy is closely integrated with the American economy, and has been for a long time, long before NAFTA came along.

We've heard this morning that our number-one trading partner in the world is Canada and some concern about Canada in the future.

Our number-two trading partner in the world is Mexico. A lot of people don't realize that. They think of Mexico almost as a Third World country that doesn't affect us very much. It's our second

largest trading partner, second only behind Canada. The two economies are inextricably linked and connected. Therefore, I think it's appropriate and proper that the United States concern itself with doing what it can to keep Mexico strong and stable in terms of their economy.

When the first proposal was made to us, involving a $40 billion loan guarantee program, I had some problems with it. I got involved in conversations with Secretary Rubin and Chairman Greenspan about some of those problems. I am one who suggested to them that, while I wanted to do what we could to help stabilize the Mexican economy, I didn't think their proposal was going to fly. I didn't think it was going to work. I told them that and recommended to them that they look for an alternative.

When the alternative was announced, I'm one who went to the Floor and said, "This is a better deal. The alternative makes more sense than the first proposal that we had made and, in general outline, I'm willing to support it and give the Administration my blessing on going ahead on it."

I did so, as I announced on the Floor, for three reasons.

No. 1, it appears there was less exposure to the American taxpayer because, No. 2, there were going to be some partners. I was very distressed at the idea in the first bailout suggestion that Americans would go it absolutely alone. I wanted to see some of the other countries of the world involved. In the deal that was announced by the President, it appeared there would be some other countries. We would have some additional participation.

No. 3, and perhaps most important to me, I saw in the arrangement announced alternatively, that there would be involvement from the Federal Reserve. This would not be a deal run entirely by officials in the Treasury, but that Chairman Greenspan and the expertise available to him at the Federal Reserve would be involved in working this out with the Mexicans.

Then, I did not say this on the Floor but I discovered it afterwards, another reason why I liked this deal better than the $40 billion loan guarantee, was that which the Chairman has already referred to.

There are monthly reports to this Committee, which would not have been called for under the first deal, monthly reports which he's now enforcing with these hearings.

As we got into the details, after having the broad outlines of the deal made clear, I began to have my disagreements with the Administration and with Secretary Rubin, and that's when we began to have the series of phone calls to which I have referred.

At base, my disagreement comes fundamentally with the issue that Congressman LaFalce touched on. What is the purpose of the American assistance to Mexico?

We've talked about the mechanics of how the assistance will be administered, but what is the purpose of the assistance?

I was shocked when, at the signing of the deal, the finance minister of Mexico, Mr. Ortiz, told us the purpose was to strengthen the Mexican banking system and to put money and capital into Mexican banks.

That was never my intention. I had never indicated that I was going to support that as the purpose of the deal.

My assumption, and I've stressed it very strongly to the Secretary, as I say, we've had a number of conversations about this, was that the purpose of this effort would be to revalue the peso. That's the phrase that Congressman LaFalce used in his testimony. He says he wants to give U.S. assistance to revalue their peso.

Who would know better how to do that than our Federal Reserve System? That's why I liked the second proposal, because it brought the Federal Reserve System into it, which meant we had an avenue with which we could work toward revaluing the peso.

Now it appears that the effort is not to revalue the peso, but to do a number of other things, among which would be putting capital into the Mexican banking system. I, as I say, have had some problems with that.

In this morning's Wall Street Journal—you have to read the paper every morning on this because the crisis is unfolding daily—I pick out two items that I would call to the attention of the Committee. This is from this morning's paper, one paragraph, it says:

> Analysts say that the peso's weakness stems partly from the Mexican government's delay in announcing a new economic recovery plan. Investors have been waiting weeks to hear some word on a new plan which will establish government targets for inflation, economic growth, and the peso's value.

Waiting weeks. That may be one of the reasons why everything is going to pot, because we have no decisive action, even weeks after the details of the deal were announced.

The next paragraph, and this one distresses me and I find myself in agreement with my friend from Florida:

> People familiar with the deliberations say senior officials would like the new economic program to include a package of tax increases, which would allow the government to maintain a relatively high level of spending for social programs and other projects. But such proposals have upset business leaders here and tied up negotiations.

I think that's probably a bit of an understatement, to say those proposals have upset business leaders and tied up negotiations.

If our money is going to go to support a government that is dedicated to a package of tax increases and maintaining a relatively high level of spending for social programs and other projects, perhaps we ought to admit Mexico as the 51st State and say, "Well, let's deal with the welfare projects down there the way we deal with welfare projects in the United States."

There is not one mention there about what is most important to me, which is the revaluation of the peso. I come back, once again, to Congressman LaFalce's statement. He was on the opposite side of the NAFTA debate than I. He said he opposed NAFTA. I supported NAFTA. He made a very clear and logical point, though, when he said that the success of NAFTA is tied to the dollar-peso relationship.

You cannot create a free trade zone that works and have one of the partners to the deal turn around immediately and say, "Beggar thy neighbor. I am now going to take back through currency devaluation what I gave you in tariff negotiations."

That is the core of what we're talking about, Mr. Chairman. The dollar-peso relationship, the sanctity of that relationship, during the negotiations in NAFTA, which I took as having been made in good faith, now being trashed and the deal that I endorsed on the

Senate Floor was endorsed with the assumption, on my part, that it would be, using Congressman LaFalce's phrase, U.S. assistance to help the Mexicans revalue their peso and move back away from the breaking of faith that occurred with respect to the whole NAFTA circumstance when the peso was devalued.

So I would hope, Mr. Chairman, as we proceed with these hearings, that we would not lose sight of that fundamental question of what is the assistance supposed to accomplish?

As one who has endorsed the Administration's efforts to support Mexico, and still does, the general proposition because, as I say, of the tremendously close integration between our two economies, just by virtue of geography, I would say, if we are talking about assistance for a series of things that have nothing to do with the dollar-peso relationship, you're going to lose the support of this Senator.

If we're talking about activities involving the expertise of Chairman Greenspan and the power of the Federal Reserve Board to do something to revalue the peso back toward where it was at the time the NAFTA agreement was made, then this Senator will hang in there and do what he can to help accomplish that goal.

It's not a question of are you for Mexico or are you against Mexico or are you for the Administration or against the Administration. It's a question of what are we trying to accomplish at the end of the day, and I want to be very clear what I would want to accomplish at the end of the day in terms of any U.S. participation.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Grams.

OPENING STATEMENT OF SENATOR ROD GRAMS

Senator GRAMS. Thank you very much, Mr. Chairman. I have just some brief observations I would like to make this morning.

Like you, Mr. Chairman, I also have some major concerns about the handling of the current Mexican crisis. Specifically, the President's decision to use $20 billion in the Exchange Stabilization Fund to bail out the peso.

It's bad enough that the President did an end-run around Congress and our responsibility to oversee the use of public funds, but what's worse are the possible consequences of this action, both for the taxpayer and for the stabilization of our own currency.

Before the United States embarks on this rescue mission, several questions need to be answered.

What guarantees do we have that Mexico will follow through on economic reforms needed to stabilize their economy?

What assurances do we have that we will be able to receive the proceeds from Mexico's oil reserves in case they default?

Why, at a time when the U.S. dollar is in a free-fall, are we using over half of the Exchange Stabilization Fund to stabilize the peso?

What impact will there be on United States–Mexican relations if we, in fact, become Mexico's banker?

Until we receive answers to these questions, we are abdicating our responsibilities as guardians of the public treasury and the American people will have no one to blame but us if something goes wrong or sours in Mexico.

That's why I support increased congressional oversight of the Exchange Stabilization Fund and the forthcoming legislation, to be introduced by the Chairman, requiring congressional authorization for any Exchange Stabilization Fund transfer of $5 billion or more per year to any one specific country.

So, I want to thank you, Mr. Chairman, for calling this hearing and I look forward to hearing what the witnesses have to say in their testimony.

Thank you.

The CHAIRMAN. Senator Frist.

OPENING STATEMENT OF SENATOR BILL FRIST

Senator FRIST. Thank you, Mr. Chairman. I'll be very brief.

On January 31, 1995, the President rushed to commit at least $20 billion of the American taxpayers' money to bail out Mexico. The President's bailout plan appears to be based on the idea that the Mexican economy is fundamentally sound, does not need reform, and is merely facing a short-term liquidity crunch.

With Mexico continuing to suffer from severe economic and political instability, I am deeply concerned that the American taxpayer is going to be stuck with billion-dollar losses from an ill-conceived plan based on false assumptions.

In the hearings over the next 2 days, we must find out why the President has put so much of the American taxpayers' money at risk and whether the risks that the President has taken with this bailout plan are really justified.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Bond.

OPENING STATEMENT OF SENATOR CHRISTOPHER S. BOND

Senator BOND. Thank you very much, Mr. Chairman. These are important hearings you're holding today and tomorrow because I do believe the Administration's Mexican bailout deserves close congressional scrutiny.

I would say that I'd like to associate myself with the remarks of the Senator from Utah, who has played a very valuable role in this. I believe his comments point out many things that we should take into consideration.

I am skeptical that we ought to be trying to second-guess the market by attempting this intervention in the first place. I can assure you that the people of my State universally think it was a bad idea. Furthermore, what's worse, it doesn't even appear to be working. In the month since the Administration announced its plan, the peso has continued to slide, the bolsa continues to lag, and the Mexican economy appears headed for the tank. To make matters worse, it can be argued that the peso is dragging the dollar down with it.

Also, there's the question of what Mexico's problem really is. What is causing the deterioration of the economy? The Administration has been telling us that this is merely a short-term crisis of confidence, a liquidity problem, at worst.

Yet, respected mainstream economists such as Bill Seidman and Larry Cudlow have disagreed, arguing that the Mexican economy

needs fundamental reform, not tax increases or more social spending, to deal with its underlying problems.

Now, recent events, which have already been noted, are starting to make the morning news, resembling a bad novel more than a newspaper, forcing us to ask if the problem goes well beyond economics to basic political and societal problems.

If that is the case, then are we simply throwing good money down a rat hole?

I'll be very interested to hear our witnesses today and tomorrow comment on whether they still adhere to their assessment of a month ago, that Mexico simply faces a liquidity crisis, or will our witnesses say that, given recent developments, they now believe Mexico faces a more fundamental political problem that should force reconsideration of the plan they've undertaken?

The issue I think we ought to focus on today, however, is the use of the Exchange Stabilization Fund by the Administration. It appears we have several witnesses who will be able to shed some light on that topic.

This use of the Exchange Stabilization Fund just doesn't smell right to me. This is a fund that, according to the authorizing statute, was established "for the purpose of stabilizing the exchange value of the dollar." Let me note, it's not the peso or other foreign currencies, but the dollar.

The day the plan was announced, I had the privilege of sitting in on a hearing called by you, Mr. Chairman, and I asked a very simple question:

> What will happen if we run into a serious exchange rate problem with the dollar during the 7 to 10 years it was being talked about for loans and guarantees to Mexico?

Unfortunately, we didn't get to wait 7 to 10 years for the chance to find out. We have been watching the dollar slide over the past weeks.

Although I realize there may be many reasons for the slide, I have my own personal view that the Mexico situation and the use of the Exchange Stabilization Fund to address it have played a major role.

I note in the testimony of Mr. William Seidman, in case he doesn't get to give that testimony today because of our opening statements, I think he notes on page 2 a very important point, that the use of this fund or other funds doesn't work, except perhaps temporarily. He says:

> The United States needs a stable, fully-valued dollar, and that can only come from sound economic policies. It seems beyond question that two U.S. economic decisions, the Mexican bailout plus the defeat of the Balanced Budget Amendment, helped send the dollar on its recent slide when they were piled on our long record of low savings and large foreign borrowings.

I think that is a very profound statement that we should consider carefully.

Bottom line, as I've said earlier, this deal just doesn't smell right. It would appear that the use of the Exchange Stabilization Fund is, at best, beyond the spirit of the law which created the fund, if not a violation of the law itself.

While I tend to believe it makes sense to have a facility like the Exchange Stabilization Fund, which gives the President wide Exec-

utive Authority to deal quickly with exchange rate problems that arise, I think it may be time to consider whether we need to modify the law governing the Exchange Stabilization Fund.

Perhaps it is time for strict controls on the use of the Fund, more specific conditions on future swap agreements, and stronger oversight by Congress.

These hearings should allow us to address some of these questions. I look forward to following the witnesses' testimony, both today and tomorrow, and discussing these issues and this testimony with you, Mr. Chairman, and the other Members of the Committee.

The CHAIRMAN. Thank you, Senator.

Senator Sarbanes.

OPENING STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Thank you, Mr. Chairman. First, let me make it very clear, I intervened when Congressman Istook spoke because I don't think anyone ought to appear before this Committee and be able to start down the path of what I regarded as character assassination.

I welcomed the comments that were made by Senator Bennett and the Chairman's concurrence in his remarks on that particular issue. It's one thing to examine the substance of a policy, but for the Congressman to come over here from the other side and start engaging in this heavy innuendo with respect to the Secretary of the Treasury, it just seemed to me, outrageous.

As long as I sit on this Committee, I'm not going to sit here and tolerate that kind of testimony. I think it was very unfortunate that it took place this morning. I think it needed to be called to account, and I welcome the indications by the Chairman in that regard.

Now, I want to address just a couple of matters which have been raised here that go to the process or to the form. We'll have plenty of chances tomorrow, when the Chairman of the Federal Reserve, Mr. Greenspan, and the Secretary of the Treasury are here, to hear the case for the substance of this proposal.

It's been asserted here this morning that there's been an end-run around Congress—going around the people's representatives.

That doesn't really square with the history. That's a real piece of revisionist history, it seems to me, and I think we just ought to be clear about that.

Senate Majority Leader Dole, on January 31, 1995, was reported in the press as stating, and I quote the story:

> Dole said he had checked with other Senators, including some who had opposed Clinton's request for $40 billion in loan guarantees for Mexico, before deciding to write the letter.
>
> 'In my opinion, most everybody's on board supporting Clinton's new plan to instead commit $20 billion from the U.S. Currency Exchange Stabilization Fund,' Dole said.

Speaker Gingrich was quoted in the press as saying:

> The President's action was defended by an unlikely ally, Newt Gingrich, the Speaker of the Republican-controlled House of Representatives.
>
> 'The President exercised his authority,' Mr. Gingrich said today. 'He took a tremendous burden on his shoulders. He did what key leaders felt was necessary.'

Of course, the key leaders issued a statement with the President. This is on January 31, 1995, a statement by President Clinton, Speaker Gingrich, Minority Leader Gephardt, Majority Leader Dole, and Minority Leader Daschle. I just want to quote from that statement:

> We agree that, in order to ensure orderly exchange arrangements and a stable system of exchange rates, the United States should immediately use the Exchange Stabilization Fund (ESF) to provide appropriate financial assistance to Mexico.
>
> We further agree that under Title 31 of the United States Code, Section 5302, the President has full authority to provide this assistance. Because the situation in Mexico raises unique and emergency circumstances, the required assistance to be extended will be available for a period of more than 6 months in any 12-month period.

It then goes on to discuss various conditions that will be attached to the assistance, the participation of other nations, and of international financial institutions.

Continuing with the statement by President Clinton, Speaker Gingrich, Minority Leader Gephardt, Majority Leader Dole, and Minority Leader Daschle:

> We must act now in order to protect American jobs, prevent an increased flow of illegal immigrants across our borders, ensure stability in this hemisphere, and encourage reform in emerging markets around the world.
>
> This is an important undertaking. We believe that the risks of inaction vastly exceed any risks associated with this action. We fully support this effort. We will work to ensure that its purposes are met. We have agreed to act today.

Now, various people at the time, Members of Congress, expressed support for what was being done. I think there was a general sentiment that action had been taken and, I guess, some relief in Congress.

In fact, there's a story that appeared in the "Financial Times" of London on February 16, 1995, in which it says that:

> Speaker Gingrich, in a discussion with Chief of Staff Panetta said, 'If the President acted on his own, Congress would breathe a huge sigh of relief.'

It's one thing, I think, to examine the substance of this policy and discuss it from that point of view, but I think it's a rewrite of history to now assert that there's been an end-run around Congress.

In fact, there was extended consultation and meetings, a number of meetings, held on the Hill involving Chairman Greenspan, Secretary Rubin, and a broad cross-section of Congress, Members of the House and Senate. That took place, repeatedly, in the period leading up to moving ahead to try to obtain the guarantees.

Now, I haven't quoted the statements of the leaders in support of the guarantees. That was a position then that didn't seem to work, so they went to the Exchange Stabilization Fund.

I think questioning the use of the Fund as a policy matter is one question, but to question its use in implying somehow that something improper was done I don't think squares.

There have been legal opinions that have upheld the use of that Fund. In fact, I'm holding now, in my hand, a memorandum to the General Counsel of the Treasury from the Assistant Attorney General on the use of the Exchange Stabilization Fund to provide loans and credits to Mexico.

So, Mr. Chairman, I'm quite prepared to look at the substance of this policy, which I assume is what we'll be hearing about from

these witnesses. I do think they have a burden to also discuss what, if anything, they would do and, if nothing, what the consequences of that would be.

I don't think it's a free ride that you can just critique—I mean, we're confronted with a problem and if you think nothing should be done you need, then, to deal with all the consequences others have set out as to why they think something should be done.

If you think something should be done, but done differently, I think you carry the burden to lay out what that ought to be and to sketch out why it might have some reasonable chance of success.

I don't think there's been an end-run here. My perception is that everyone who's dealt with this issue has wrestled with a very tough problem in a very honorable way. I very strongly resist casting aspersions on people's fundamental commitment to the public interest, as occurred earlier in the hearing this morning.

Thank you.

The CHAIRMAN. Senator Moseley-Braun.

OPENING STATEMENT OF SENATOR CAROL MOSELEY-BRAUN

Senator MOSELEY-BRAUN. Thank you, Mr. Chairman. Maybe I was fortunate. I was in the Finance Committee this morning and missed the exchange to which Senator Sarbanes refers, but I would associate myself with that portion of his remarks because, it just seems to me, we really don't need to get mean-spirited around here. It doesn't help things a whole lot and it certainly doesn't add any light on a subject that I think we all have a real interest in getting more information about.

At the outset, Mr. Chairman, I want to make it clear that I come to this hearing as an original opponent of the peso rescue plan that was originally proposed and that we've now entered into.

I thought it was vital that, for the investors who had earned such high returns on their Tesobono investments and the like and who had taken high risks in investing in Mexican securities, they take the consequences of their decisions.

In short, I thought it was inappropriate for both equity and policy reasons to bail out the investors.

Having said that, however, I must also say that the issue has now been decided and I don't think it is in our national interest to try to undo the decisions that have already been made.

As my colleagues on the Committee know, the Treasury and the Federal Reserve made every major decision relating to Mexico and its currency jointly and in full partnership. The joint congressional leadership, as Senator Sarbanes points out, was consulted in advance before the Administration made its legislative proposal and before it acted using the Exchange Stabilization Fund.

The joint leadership of Congress, including the Speaker of the House, Newt Gingrich; Chairman Gephardt, the House Democratic Leader; Majority Leader Dole; and Senator Daschle, the Senate Democratic Leader, were all consulted in advance and all four fully endorsed both the legislative option and the Exchange Stabilization Fund option that was ultimately used, which gets me to a point about that.

Under the law, 31 U.S.C. 55302(c)(1), this was the procedure that was allowed with regard to the Exchange Stabilization Fund.

The law also requires that the Secretary of Treasury submit to the Senate and House Banking Committees detailed financial statements for the Exchange Stabilization Fund every month, that the statements should show the agreements that are made or renewed and transactions and the like, and that the Secretary is called on to report to Congress on an annual basis the operations of the ESF.

The CHAIRMAN. On that point, would the Senator yield for an observation or a question?

Would the Senator then conclude, given her reading of the law, that we then are entitled to all of the facts and information as it regards the methodology of carrying out this agreement, all of the transactions and all of the agreements? All of them.

Senator MOSELEY-BRAUN. Listen, I think we ought to have as full disclosure as possible, but that raises the question——

The CHAIRMAN. One of the things——

Senator MOSELEY-BRAUN. That raises the question——

The CHAIRMAN. I'd like to point this out to my colleague and friend. One of the problems is that the Administration is asserting Executive Privilege. Now, you can't have it two ways. You can't be saying we have this fund, the law clearly spelling out that—all of the details, obviously, should be made to this Committee and to our brethren in the House, and then have the assertion of Executive Privilege.

I don't know whether the Senator was aware of that, but that is one of the obstacles we are beginning to encounter in terms of seeing what is taking place.

I just share that with you.

Senator MOSELEY-BRAUN. I think that there is no claim of Executive Privilege with regard to the reporting information the law requires Treasury to give.

The CHAIRMAN. I agree with you.

Senator MOSELEY-BRAUN. When you're talking about people's telephone calls and slips——

The CHAIRMAN. No, no, we're not talking about that.

Senator MOSELEY-BRAUN. That is the question I would raise.

The CHAIRMAN. I want to assure the Senator——

Senator MOSELEY-BRAUN. Mr. Chairman, can I get two words in edgewise?

The CHAIRMAN. Certainly.

Senator MOSELEY-BRAUN. I'll stop talking and let you talk. It's up to you. Either I get to make a speech or you get to make a speech. We can't make a speech at the same time.

The CHAIRMAN. I understand and I certainly yield back to you, and I apologize if that was the impression.

Senator MOSELEY-BRAUN. We're both coming from——

The CHAIRMAN. No, no. You're right.

Senator SARBANES. You both come from tough towns, no question about it.

[Laughter.]

Why don't you let Senator Moseley-Braun finish her opening statement and then, Mr. Chairman, you may want to comment on it. I want to comment on it because I have the law right in front of me and we can carry that discussion on a bit, but I think Sen-

ator Moseley-Braun ought to be able to finish her opening statement.

Senator MOSELEY-BRAUN. Thank you. Thank you very much, Senator Sarbanes.

Mr. Chairman, again, the point I just wanted to make was that the law already tells the Secretary what he must do. I don't see that we have to go—I'm looking at this concurrent resolution and, frankly, it's like why? Why are we doing this?

To the extent that it reiterates what the law says, it's unnecessary. To the extent that it goes beyond what the law says, it seems to me it does violate the prerogatives of the Executive and it does—frankly, it seems to me to be posturing to the sense that it goes beyond what it is the law says we should do.

Now, having said that, I would say also, Mr. Chairman, that the precipitous fall of the Mexican peso was not anybody's fault in this Administration. Those weren't decisions made in the United States that made the peso fall. Those were decisions made in Mexico City. It was mistakes made by the Mexican government, not the Government of the United States, that created the liquidity problem and the resulting devaluation of the peso.

It was Mexico that permitted excessive growth of its money supply and it was Mexico that issued the short-term notes that made it so vulnerable to the events that have unfolded in recent weeks.

Although Mexico is a sovereign nation and not a trust possession of the United States, I do agree that U.S. interests require, during the last year, that our Government keep a careful watch on economic policy decisions made by the Mexican government. That seems to have been done.

The Treasury and the Federal Reserve were not the last to see the unfolding problems in Mexico. In fact, they seem to have uncovered the risks before many respected private sector economists did.

It appears that the Treasury and the Federal Reserve acted on what they knew, communicating their concerns to the Mexican government well before the crisis hit.

I cannot agree with the implicit suggestion in a memo written by a member of the Committee staff, however, that Treasury officials had a duty to warn U.S. investors that the peso was overvalued. That is a road, Mr. Chairman, I don't think we should start down.

We have only to look at our own financial markets to see the problems. For example, should the U.S. Government have warned New York City bondholders that its creditworthiness was eroding when the city was having its problems?

I don't think so. New York City ultimately needed Federal assistance, but what about other communities? Would that kind of Federal action have made it impossible for them to have successfully resolved their differences on their own?

Did the U.S. Government have a duty to warn the shareholders and bondholders of Penn Central, the railroad in the Northeast that pre-dated Conrail, that bankruptcy was imminent?

Did the Federal Government even have a responsibility to know that fact, a fact that the private bond-rating agencies had missed?

Did the Federal Government have a duty to warn the holders of the securities of a number of Florida or North Carolina communities that these communities had inadequate building codes and

inadequate enforcement of the codes they did have, which put a repayment risk on them in the event of a natural disaster?

The answer, I think, to those questions is clear. Of course not.

We have a system of private enterprise and in that system, private decisionmakers decide what risks they want to take.

The Federal Government's role within the United States is to try to set up the marketplace so that investors have the means to get the information they need from those who have it. It is not the Federal Government's responsibility to warn individual investors of the risks they decide themselves to take.

In the case of Mexico, the Federal Government's authority does not even extend that far. The United States does not have the power to ensure that Mexican financial disclosure standards are identical to U.S. standards.

Again, this is a sovereign country we're talking about.

American investors in Mexican securities knew what information was available when they decided to buy those securities. They decided to take the risk, as was their right in a free society.

The securities, however, were Mexican securities. Nowhere under the terms of those securities or under U.S. law does it say that the U.S. Government has an obligation to provide, or should provide, information to investors above and beyond the information those markets provide to those investors.

Putting that kind of obligation on the Federal Government and on the Secretary of the Treasury is inconsistent, it seems to me, with both our basic system of Government and our basic economic system.

What is more, it would put the United States in the position of explicitly influencing foreign financial markets and that, too, is a road that we should not take.

The Mexican currency crisis deserves the time and attention of this Committee, Mr. Chairman. However, trying to decide to modify the law now governing the use of the Exchange Stabilization Fund is like trying to learn how to swim in the middle of the pool or changing the rules in the middle of the game. It does not help us to begin to address the fundamental law that's governed the Exchange Stabilization Fund for a number of years in the middle of this crisis.

However, and I think there's a window of opportunity here, Mr. Chairman, it would be very helpful and important if this hearing provided us with more information regarding the policies of the Mexican government calculated to restore their economy to fiscal and monetary health.

What do they plan to do? How do they plan to deal with their peso and its position overall?

United States support, even international support, cannot prop up the peso indefinitely if their domestic decisions do not respond prudently to economic fundamentals.

Unfortunately, the credibility of the central bank—it has been suggested that that credibility is underwhelming, but I think we can begin to start a dialog and to share information regarding what are the decisions that are pending? What is the information? What is the plan? Why is it taking the plan so long to come forward?

We can get that kind of information and use this hearing as an opportunity, it seems to me, to get the information we need in this regard instead of having this hearing turn into a set of recriminations, ad hominem attacks on each other, and political posturing.

It doesn't seem to me that serves a real purpose when we can actually use this opportunity to get some fundamental information that will be helpful in terms of which way we go next in this situation.

With that, Mr. Chairman, I yield the Floor.

The CHAIRMAN. We'll call our first panel: Dr. Hanke; Dr. Meltzer; Bill Seidman; and Mr. Bergsten.

Senator SARBANES. Mr. Chairman, while the witnesses are making their way to the table, I would just like to add, in light of the conversation or the exchange you and Senator Moseley-Braun engaged in, what the statute requires in terms of reporting requirements set out in statutory language.

Now, if a request is made that exceeds the requirements set out in the statute I think it is legitimate, if the Department chooses to do so, to question that request.

It's my understanding that some of your differences with them involve that very issue, but the statute states the nature of the reporting they should make. If the request for information exceeds what the statute requires, then there's a separate issue raised as to whether the Department chooses to provide that information, but they would not be outside of the statute. They'd be working within the statute.

The CHAIRMAN. Senator, this is an unprecedented amount of money. Even the Treasury's General Counsel indicates, and I quote from page 6:

> Although loans and credits are clearly permitted under the ESF, their purpose must be to maintain orderly exchange arrangements in a stable system of exchange and not to serve as foreign aid.

Now, we certainly have a right to take a look and to examine because we have not been given the information as it relates to how much money has been drawn down or what is taking place with that money. I understand there may be noble purposes, but we have an absolute duty and an obligation to examine this.

Senator SARBANES. No one's questioning that.

The CHAIRMAN. I didn't interrupt, and I have to suggest to you that we play by the same rules.

I will listen to your statements. That doesn't mean that I agree by my acquiescence in not saying anything.

The fact of the matter is, notwithstanding that there may have been a number of congressional leaders, three, four, six, eight, or ten, and it's my belief, that a transaction of this size involving, maybe, the very stability of the American dollar should have had congressional approval.

I understand I have colleagues, Republicans and Democrats in leadership, who may have felt the other way, but I think the American people, certainly, at the very least, have a right to know how their taxpayers' dollars are being spent, how this program, this fiscal rescue, the propping up of the peso, if that's what it's intended to do, is being carried out. That's the purpose of the hearing.

Mr. Seidman.

Mr. MELTZER. Mr. Chairman, may I interrupt?

The CHAIRMAN. Yes.

Mr. MELTZER. I'm testifying here with the expressed reservation that I have a 1 p.m. plane to catch.

The CHAIRMAN. Then, recognizing the situation, we'll call on you. Dr. Meltzer.

OPENING STATEMENT OF ALLAN H. MELTZER, Ph.D. PROFESSOR OF PUBLIC POLICY, CARNEGIE MELLON UNIVERSITY, PENNSYLVANIA

Mr. MELTZER. I thank you very much, Mr. Chairman, for your courtesy. It is a pleasure to be before this Committee again, as I have on many occasions in the past 30 years.

It is a pleasure, particularly, to talk about an issue that is an important problem. I commend the Chairman for his diligence in trying to see that there is a thorough discussion of the issues relating to the Mexican–American agreement and that there be some limitation placed upon the amount to be spent under the agreement.

In fact, I would go further, Mr. Chairman, and suggest that the Exchange Stabilization Fund is an anachronism of the 1930's. Congress should close down the Fund. There is nothing that the Fund can now do that could not be done through intervention by the Federal Reserve and, usually, the Federal Reserve intervenes with the Treasury in these operations and shares in those operations.

So an off-budget solution to the problem seems to me to be far less desirable than having the Exchange Stabilization Fund close down.

In the interim, of course, I share the Chairman's belief that there should be a limitation on the amount of money that is to be expended under a pending agreement that has already been made. Congress should look into further expenditures and authorize them as part of the regular budgetary process of the United States.

I have distributed to the Members of the Committee some charts giving some idea about the background of Mexico during the last 2 years.

The first chart, which is labeled "Monetary Policy in Mexico," shows the growth rate year over year of the monetary base. This is the amount of money which is emitted by the Bank of Mexico. That is independent of anything that goes on in the private sector. It's what the Bank of Mexico chose to do.

The chart shows very clearly, Mr. Chairman, that the Mexican government, from 1992 into 1993, pursued a tightening monetary policy. Beginning in 1993, late in the summer of 1993, it began an ever-increasingly expansive monetary policy. That monetary expansion brought the rate of growth of the monetary base back to the range in which it had been before.

Mexico was proceeding with an inflationary monetary policy, a factor not unknown in elections in other countries, including this one, but one which had been repeated in Mexico in 1976, in 1982, in 1988, and again in 1994.

The beginning of the current problem in Mexico is a repetition of the problem Mexico has had in each one of its previous election years for the last four elections.

The second chart shows what was happening during that period.

People in Mexico were not unaware of what the conditions in Mexico were. The solid, small line shows government purchases, debt purchases by the Bank of Mexico.

You can see that Mexican citizens, shown by the broken line, were selling off their government securities. The Bank of Mexico was buying them. That is, at auctions if, for example, Tesobonos, cetes, and other securities were not able to be sold at the interest rates prevailing in the marketplace, the Bank of Mexico would buy up the bonds. That was one of the sources of increase in the monetary base.

Below, we see the holdings of cetes, short-term securities, essentially treasury bills of the Mexican government.

We see from the broken line that the Bank of Mexico was buying, particularly in the month of March, after the assassination of candidate Colosio. But they also bought at very high rates during most of the spring and into the summer. Whereas, holders, foreign and domestic holders, were selling, the Bank of Mexico was buying.

That, too, was a source of expansion of the monetary base and money growth in Mexico. Mexico was proceeding with an inflationary policy.

The third chart which I have put up or made available shows the real appreciation of the Mexican peso.

Mexico was becoming a costly place to produce, or a more costly place to produce and buy, but not extremely so. The top chart uses consumer prices of the Bank of Mexico and the Labor Department here. The number printed by the Bank of Mexico shows an up-valuation of the real exchange rate of 11 percent on consumer prices and 8.8 percent on wholesale prices during this period.

Mexico was becoming a more expensive place to produce. One of the reasons for the big importation of consumer goods was that much of the revaluation, the real revaluation, the higher real cost of goods, was on the consumer side rather than on the producer side.

So Mexico, as a result of its inflation, was getting an increasing current account deficit and having problems. But the principal problem was an inflationary policy, the lack of serious policy to control inflation.

The Bank of Mexico, by statute effective on April 1, has the most stringent monetary policy system in the world. They are one of the most independent banks by law of any country in the world.

Unfortunately, the law is not very thoroughly observed and the Mexican government—the Bank of Mexico was proceeding with a policy of inflation.

What was Mexico's response to this problem?

During the election, they did nothing. After the election, they had an opportunity to do something. That was the time to take concerted action to slow the rate of inflation. It may have been possible, at that time, to hold the exchange rate at 3½ pesos per dollar by pursuing a tight monetary policy and by going to the holders of Mexican bonds and saying, "We're sorry. Once again we have to tell you if you were in for 3 months, you're now in for 3 years. Let's talk about the terms of the work-out."

Those would be two things which would have been necessary to do in September, after the elections were over. It's too much, perhaps, to ask during the election year, before the election, that the Mexican government would take that action, but it was certainly true that's what they should have done, in my opinion, after the election.

By December, not having done that, Mexico proceeded with a process which has led to increasing problems in Mexico.

By December, having spent most of the $30 billion of reserves with which they started the year, the Bank of Mexico had no choice about propping up the value of the peso. What it had to do at that time was devalue, as it did.

What it should have done, in my opinion, was to float the peso. Float the peso, tighten its monetary and fiscal policies, make a credible effort to convince the investors that, even though they had no reserves to shore up the peso, they were not going to go through a series of sharp devaluations over and over again, and, of course, go to the bondholders and tell them, you're in for 3 years, not 3 months. Let's talk about the terms.

They didn't do that. Instead, they delayed. They have not come with a credible, anti-inflation policy yet. That's why the peso continues to drop, in my opinion, on world markets. It is because there is no program by the Bank of Mexico or by the Mexican government which is credible to the investors. To tell the investors we're going to privatize a few assets and deregulate, that's a desirable thing for Mexico to do, but that's not a program to stop the currency drain.

To stop the currency drain, Mexico needs to tighten money, to tighten its fiscal policy a bit, and to face its bondholders and tell them we are in default once again. We have to work out this arrangement for you.

What has the present set of policies done?

It's a mistake, in my judgment, for Mexico. It's a mistake, in my judgment, for the United States. Mexico still has the debt overhang from its previous financial crises. Now it's going to add additional debt.

What help is that to the Mexican people? None.

At the end of the day, Mexico, if it is to solve this problem, will solve it by the steps that I described before. It will float the peso. Floating the peso means that it becomes costly for people who want to run with their money out of Mexico. They have to pay to get out. Floating means more of them will stay in. That will give them some encouragement to stay there rather than take the large losses that would be required under a floating currency.

It will tighten its monetary and fiscal policies.

Finally, it will face up to the long-term problems that I think were well expressed by Senator Mack in his statement to the Committee. Namely, Mexico has to put itself on a credible program of privatization, reform, deregulation, and monetary and fiscal policy aimed at price stability.

There are two main arguments that have been used. One of them is that we should fear the immigration from Mexico. To stop immigration, we don't lend money. We police the border.

The other argument is made that, somehow, we are helping the Mexicans. We are not helping the Mexicans, in my judgment. What we are doing is harming the Mexicans, saddling them with a big burden for the benefit of those people who have already and will, if the Mexicans continue to prop up their exchange rate, get out on more favorable terms than they ought to get out on, having taken the risks of investing in Mexico.

So, in my judgment, it is a mistake, as I said, for the United States. It is a mistake for Mexico to embark on this policy.

What we should do is close down the Exchange Stabilization Fund, which I described earlier as a relic of the 1930's.

All of the actions the Exchange Stabilization Fund takes can be taken by the Federal Reserve. They should be taken in the open.

We should close down our lending to the International Monetary Fund, not throwing more good money after bad. We should, at a time—we should avoid the problems that we have gotten into. The problem we have is very similar to one this Committee knows very well—the problem of moral hazard in the savings and loan industry.

If you put in a lender who is going to bail out institutions that are in trouble, you're going to find more institutions in trouble.

The problem in Mexico is very similar to that. What we need to do is encourage the Mexicans to do what they, and we, know is the right thing to do, and the only path which will eventually solve the problems in Mexico.

Thank you.

Senator BENNETT [presiding]. Thank you, Dr. Meltzer.

What time is your plane?

Mr. MELTZER. My plane is at 1 p.m.

Senator BENNETT. If I could ask one quick question, and give each of my colleagues one quick question, could you stay for that?

Mr. MELTZER. Certainly.

Senator BENNETT. What would happen if Miguel Mancera announced he was not printing any more pesos and Alan Greenspan announced he was buying pesos? What would happen?

Mr. MELTZER. I think, if Mr. Mancera said he was not printing any more pesos, the interest rates would temporarily rise very rapidly in Mexico. Once people were convinced he really meant that, confidence in Mexico would increase. People would begin to look at Mexican assets as cheap at the current exchange rate and would begin to invest in Mexico.

As to the second part of the question, I think it is a mistake for the United States to buy foreign currencies of any kind under almost any set of conditions. So it would be a mistake for Mr. Greenspan to shore up the peso.

Senator BENNETT. Thank you.

Senator Moseley-Braun.

Senator MOSELEY-BRAUN. Very briefly, this Exchange Stabilization Fund has been used in the last 15 years to extend guarantees on three occasions.

In 1982, it provided support to Brazil during a financial crisis.

In 1983, it assisted Yugoslavia, which was suffering a hard currency crisis.

And in 1994, it guaranteed to assist an international effort to help Macedonia pay off its arrears.

In all those cases, it worked out and the ESF was repaid. Nobody's defaulted here previously. While we have an unpopular deal here, it is, nonetheless, a complex deal in which our national interests are clearly bound up one way or the other.

You say policing the borders is the answer to immigration. There are others who are not so sure, frankly, that's the only thing we can do.

The point is, in light of the fact that the history with the Exchange Stabilization Fund has been a good one and has acted as a positive safety valve, why, then, your suggestion that we just shut it down altogether. Is that more a function of this particular crisis or of the nature of the Fund itself?

Mr. MELTZER. No, it's the nature of the Fund itself.

The Fund was established originally, as other people will testify, Senator, to help the dollar during the transition after we devalued the dollar against gold in 1934. It was supposed to make small—it was $2 billion at that time, and the $2 billion was supposed to smooth the transition during periods in which currency markets were turbulent, to make short-term transactions, and to defend the dollar.

We can discuss whether that was a sensible or a wise policy at the time, but it was certainly nothing like the policy that the Fund is now being used for. It's being used to shore up foreign currencies and, in this case, to make long-term loans, not short-term loans.

Those long-term loans, I want to repeat, are not in the interest of the United States, in my judgment, but they're not in the interest of Mexico.

The Mexicans are going to be saddled with an even bigger debt. They haven't been able to pay off the debt from 1982 and 1988. Now they're asked to assume another debt. That's a huge burden on the Mexican people for a policy that is not going to do very much.

What they need to do, they have to do without that assistance.

The CHAIRMAN. Dr. Meltzer, let me thank you. I know you have a plane to catch. We don't want to have you miss that. We certainly appreciate the historical data you have given to us.

I think it is quite illuminating, when you look at the charts and you see the pattern and when you point to it, that this is a recurring phenomenon with the Mexican government tied to the elections, and I think people begin to understand that a lot better.

Thank you very much.

Mr. MELTZER. Thank you very much, Senator.

The CHAIRMAN. Mr. Seidman, it's good to see you, Bill.

OPENING STATEMENT OF L. WILLIAM SEIDMAN CHAIRMAN OF THE BOARD, COMMERCIAL MORTGAGE ASSET CORPORATION; FORMER CHAIRMAN OF THE FDIC, WASHINGTON, DC

Mr. SEIDMAN. Thank you, Mr. Chairman, Members of the Committee. It's a pleasure to be here and I think if I could combine what Dr. Meltzer said with what Senator Murkowski said, you would have a pretty good idea of what I'm going to say.

As you know, when I was last here on January 31, 1995, it was with a message that the proposed Mexican bailout was bad for the Mexicans, bad for the United States, and bad for the world markets. Nothing that has transpired since then has changed my view, and much that has happened would appear to support it.

The Administration has said if they hadn't acted in the way they did, things would be worse. It's hard to know how it could be much worse.

My purpose here today is not to violate my mother's oft-repeated statement to me, "Never say, 'I told you so,'" but rather to discuss what we have learned from recent experiences with the new world of high velocity markets powered by computers, hedge funds, trillion-dollar-a-day trading, government interventions, and worldwide participation.

In the last few days, the world's financial community has fired a shot across the bow of the U.S. financial ship of state. The recent behavior of the dollar indicates to all who observe that, "You, too, Uncle Sam, are subject to world markets."

In my view, it also warns that no country, even the United States, is in a position to be banker of last resort to world markets. The old idea of stabilization, much as what Dr. Meltzer has just pointed out, simply is not effective in the financial world that we have created today. The U.S. Federal Reserve Board, the U.S. Treasury, the IMF, and the BIS are pebbles on the beach when the financial tides roll in.

There has been considerable discussion of whether the use of the Exchange Stabilization Fund—and, I would note, its entire net position. We keep saying that we only used half of the Fund. They used the entire net position of the Fund.

If you take the statement they give us, it says assets less liabilities, and the amount left is something around $18 to $20 billion. So, we haven't used half of it, we've used all of it, according to the statements they are supplying to the public.

Then we ask, "Well, if that has been done, does that reduce the ability of the United States to support the dollar when it is in trouble, as it has been recently?

The answer from Government officials has been, "We have plenty of resources, even with this action."

Now, some of them have said it doesn't affect our ability at all, but I noted that Alan Greenspan was quite careful not to say that, as I read his words. What he said was, "We still have plenty of ability to handle the situation."

It certainly seems strange that committing the entire Exchange Stabilization Funds net position has no effect on stabilization funding ability. That would seem to be a contradiction in terms, but I believe the real point is that the use of this or other funds to act as banker of last resort or to stabilize currency doesn't work, except, perhaps, temporarily.

The United States needs a stable, fully-valued dollar and that can come only from sound economic policies. It seems beyond question that two U.S. economic decisions, the Mexican bailout plus the defeat of the Balanced Budget Amendment, helped send the dollar on its recent slide when they were piled on the long record of low savings and large foreign borrowings.

From this experience, I think we can take note of three things for future action.

My first point is that the world market system now polices world markets. The shot over our bow is proof again that markets do not discriminate.

Like every market system, world financial competition can be brutal in governing its markets. To mitigate this harshness, the best weapon is information freely available to all market players, something that clearly was not the circumstance in the Mexican situation, and I'm not even sure all the leadership knew all of what was going on when the various commitments, that Senator Sarbanes referred to, were made.

The world certainly needs to work on a system that will close markets to those who do not clearly disclose.

My second point would be that reliance on central bank or Exchange Stabilization Fund interventions is not an effective tool for any sustained period. Thus, it is certainly appropriate for Congress to review the use of, and need for, a large Exchange Stabilization Fund.

Is it appropriate to use such a fund for long-term lending? Is the amount appropriate, given the obligations which it recently has undertaken?

Would the United States be better off to take the Fund and use its balance to reduce our deficits, and let the Fed deal with temporary stabilization problems, as has been suggested by my colleagues?

Why should such a large sum be available to any one person without congressional control?

Those are questions that I think need to be answered before this Committee, Mr. Chairman.

I would then end with the point that long-term interest rates in the United States will be determined, to a large extent, by investors world-wide, since they are our marginal lenders for something like 25 percent of our debt. We must keep our eye on them because they are the ones who are going to control, to a large extent, what happens to our interest rates and thus, to our economy.

What will foreign investors demand to finance our bad habits, budget deficits, and lack of savings?

We have fundamental economic problems that we need to address. As has been said many times in this Committee and in other halls, there will be no one available to bail us out if we don't heed the warning shot we've just seen across our bow.

Thank you.

The CHAIRMAN. Thank you, Mr. Seidman.

Mr. Bergsten.

OPENING STATEMENT OF C. FRED BERGSTEN DIRECTOR, INSTITUTE FOR INTERNATIONAL ECONOMICS, WASHINGTON, DC

Mr. BERGSTEN. Thank you, Mr. Chairman. I have a number of thoughts on the Mexican problem and I've recently given two statements on it to other Committees here in Congress.

I would like to address in my oral remarks three broader, but central, questions that have come before the Committee today.

First, has the Mexican crisis and the United States support for Mexico been a key factor in bringing down our own dollar?

Second, what about the future of the Exchange Stabilization Fund?

And third, returning to a question that Congressman LaFalce raised earlier, how do we head off similar problems in the future?

I'd like to say a few words on each of those, if I may.

On the first question, I think I yield to no one in the comments I've made over the years about the need for the United States to get its house in order, in terms of our budget deficit, our trade deficit, and our becoming the world's largest debtor country.

I was one of the few mainstream economists who supported the Balanced Budget Amendment to help move in that direction.

I must tell you, I sharply disagree with the views expressed by Senator Brown, Mr. Seidman, and others before you today that what has brought the dollar down is either our support for Mexico or the failure of the Balanced Budget Amendment.

Senator Brown's chart is gone, but it ignored two critical things.

First, it ignored the sharp bounce-back of the dollar yesterday, which I think is probably the harbinger of a turn-around, but more importantly it left out what I view as the critical element that began the sharp recent decline of the dollar: Mr. Greenspan's testimony before several of the Committees here on the Hill 2 to 3 weeks ago.

In my view, the overwhelming reason our dollar has declined in recent weeks can be explained by perfectly logical economics. The United States led the recovery from the world recession of the early 1990's. We had rapid economic growth. We've had 4 years of recovery and particularly strong growth over the last year or two.

During that period, our interest rates naturally went up and the Fed pushed rates up, particularly over the last year. During that period, the major countries elsewhere in the world, the Europeans and Japan, were dead in the water. Their economies were stagnant, their interest rates were low.

So U.S. interest rates were relatively high, and investors put money into the dollar. No more than a year ago the U.S. dollar was the second strongest currency in the world, even though we had budget deficits, huge trade deficits, and were already the world's largest debtor country. Despite these problems, our currency was strong: It was 1.75 against the Deutschemark less than a year ago because we led the world recovery.

Now the situation has fundamentally changed. We are slowing down. As a result, our market interest rates have already begun to come down. And in his testimony over the last 2 or 3 weeks, Chairman Greenspan signaled that the Fed might now stop raising U.S. interest rates and might even begin to move them downward.

At the same time, the European and Japanese economies are picking up. Their interest rates have already risen in the market. Their monetary authorities are talking about higher interest rates.

Consequently, in these huge world financial markets, there is a fundamental change in expectations about interest rate differentials. U.S. interest rates are flat or down. Foreign interest rates are rising. That means investors will move money from dollar assets to foreign assets.

It is no more esoteric than that. One doesn't have to concoct diabolical plots. One doesn't have to talk about the Mexican rescue package. One doesn't have to talk about the failure of the Balanced Budget Amendment.

I would not deny that all those things might have had some modest additive effect but, in the main, I trace it directly to the change in market perceptions of U.S. monetary policy developments and direction over the period ahead.

Let me say that I agree with Chairman Greenspan on the substance. I think it's right for U.S. interest rates now to stop rising and, indeed, perhaps to recede as our economy slows. I don't fault him on the substance of his remarks, but we have to recognize that such statements drive the international financial markets, and that's why our dollar has declined.

Before we wring our hands too much, it's also important to ask: Is the decline of the dollar a big problem for the United States?

It has not trashed our bond or stock markets. Our stock market is still recording near-record highs. Our bond market has held up extremely well. The dollar decline improves our trade competitive position a little bit by helping us bring down that massive current account and trade deficit.

So I think expectations of interest rate changes led to the dollar's decline. I think it's not a big problem, let alone a crisis, for the United States. I wouldn't worry quite so much as others have in the earlier testimony, either that the Mexican situation is what's caused it or, even if it had, that it's a big problem for the United States.

Let me turn to the second issue, which you're considering now in action terms, the role and future of the Exchange Stabilization Fund.

When I ran the international part of the Treasury Department for 4 years in the late 1970's, I was in charge of the Exchange Stabilization Fund. I sent the letters to the Chairman and Ranking Minority Member of this Committee, and your brethren on the House side, to report on the activities of the Fund, its balance sheet, its monthly profits and losses, and the like, so I have some familiarity with that process.

Let me first suggest that it is essential for the United States to have an Exchange Stabilization Fund. Contrary to what Professor Meltzer and Mr. Seidman said, the U.S. Government must have a fund of that type.

It is the responsibility of the elected and appointed officials of the U.S. Government to defend the currency, help promote international monetary stability, and use the Fund for the purposes that were laid out in the statute 60 years ago.

One can honestly debate how it should be used in a given case, but I think you in Congress would be the first to reject the notion that a fund of this type should be used only by the unelected, unappointed officials of the Federal Reserve System, rather than the officials of the U.S. Government, over whom you in Congress have direct surveillance and control.

That's point one.

Point two is that the United States has, on many occasions in the past, used the Exchange Stabilization Fund to support other currencies as indirect ways of supporting its own currency.

All through the 1960's and 1970's, every Secretary of the Treasury, every Chairman of the Federal Reserve Board said, "The pound sterling is the first line of defense for the dollar." That was correct. The pound was the second key currency at the time. If the pound went, the dollar was under pressure. As we saw when the pound was in fact devalued in 1967, it triggered a huge gold and dollar crisis.

It is often intelligent to use the Exchange Stabilization Fund to try to defend other currencies in order to directly and indirectly defend our own currency.

Those who believe that the Mexican peso problems have brought down the dollar of late, or at least added to it, are, in fact, ratifying that point. If that causal chain is correct, it's hard for me to see how they can then say that we should not try to defend the peso if failure to do so produces these adverse effects on the dollar.

The broader point, however, is that we have seen, historically, that it has been both necessary and effective to defend the dollar by defending other currencies.

The CHAIRMAN. Mr. Bergsten, first of all, I think your first point is absolutely on target and you are absolutely right. I think that is the position of the Federal Government and its elected or appointed representatives, to defend the dollar. I feel more comfortable, or certainly as comfortable, with that being the case.

In the second point you made, and I have no quarrel with that, it seems to me that a broad interpretation of the statute would lead one to believe that certainly the stability of foreign currencies, as it relates to our own currency, would be a logical interpretation, a broader one than if one were to read the statute literally, but, certainly, arguable legally and defensible. I certainly think that the courts would give great weight to that argument if you were to test it out.

Make no mistake. This Senator is not intending to move along that line, but you said, in enumerating the reasons for defending the currency, to help promote stabilization.

I'd suggest to you there are some who are saying, when we're engaged in such a massive effort, that we have now taken this to the critical point where it has become, in essence, foreign aid, that we are now talking about a plan that will be administered over 7 to 10 years, and that we are not even talking about $20 billion. We are talking about a minimum, that I am aware of, $29 billion, $9 billion having been put out by this country alone in swaps, and that we have gone well beyond anything we have ever seen, in reference to the cumulative experience of all of the dollars loaned out by the Fund.

Most of those transactions, as you are aware of, were for very short periods of time, to come in and to stop the speculation, to shore up the dollar.

I would hope that—that's a very clear difference, isn't it?

Mr. BERGSTEN. This is——

The CHAIRMAN. This is what troubles this Senator and, I think, other Members of Congress.

Mr. BERGSTEN. This is an unprecedented use of the Exchange Stabilization Fund, Mr. Chairman. You're exactly right about that.

I would not, however, characterize it as foreign aid for several reasons.

First, the money is being lent at market interest rates. There's no concessionality in terms of interest rates, which is normally an element of foreign aid.

Second, the swap part of the agreement that you referenced is short-term. It may be rolled over from 3 months to 6 months, but that is short-term.

We do not yet know how much, if any, of the actual transfer from the Fund will go for longer-term purposes or be used for guarantee purposes.

The Treasury, I think, has been properly vague or indefinite on the actual drawdown and use of the ESF monies. They've given you three categories of use that they have in mind.

But aside from those short-term swaps that have already been extended, they have not, to my knowledge, yet done any of those other elements.

I have been involved in fashioning packages of this type myself; the objective, of course, is always to have a large enough package with sufficient policy measures to be taken by the other country that you never have to use it at all.

In fact, one might make an analogy between the Exchange Stabilization Fund and the nuclear deterrent. You want to have it big enough and strong enough and credible enough that it never has to be used. That is in fact the objective of the exercise.

So, potentially, yes, it could be deployed in an unprecedented way. I still would not call it foreign aid because of the market interest rates and because, even if it did go out over 10 years, that's a much shorter maturity than what we normally think of as foreign aid, at least concessional assistance of an AID or World Bank concessional lending type.

The CHAIRMAN. I just thought it was important to try to touch on that.

Mr. BERGSTEN. It's a very important point. Actually, I wanted to go on and just——

The CHAIRMAN. Please do.

Mr. BERGSTEN. I want to make two more quick points on the ESF because this is central to your surveillance of the process.

The third point is that even when the Exchange Stabilization Fund use is not directly or one step removed from defense of our own currency, its use is both authorized by law and legitimate. You really made this point yourself.

International financial stability, as a whole, is in our national interest. For better or worse, the dollar is the world's key currency. True, it gets into trouble on its own once in a while, as we have seen now, but it is also our responsibility, and we've done this frequently in the past, to offer international rescue packages for other major currencies, as we have done for the pound sterling, as I mentioned, the French franc, and others in the past. That is in our national interest. We would not want to give up the ability to do that.

There's another reason, Mr. Chairman, why we should be able to participate in international packages to help other currencies. As

several of the witnesses have said, we, from time to time, need such help, too.

I happen to have been in the Treasury in the late 1970's when the dollar came under sharp attack. We put together a $30 billion program to support our own currency. It worked. It made a lot of money for the taxpayer, in fact.

But, among other things, we needed help from the Germans, the Japanese, and the Swiss. If we're not able to help them when they need it, they're not going to help us. In today's interdependent world, where we cannot do it all alone, we need to be in a position to reciprocate in order to get that help as well.

My final comment, Mr. Chairman, goes directly to the legislation that I understand you're considering.

With all due respect, I think it would be a mistake to put numerical limits on the individual uses of the Exchange Stabilization Fund in a given case.

I think I understand why you want to do it and I respect that, but I think it would be a mistake for the reason I indicated a moment ago.

For programs of this type to be successful, they have to be very large, very fast-moving, and very credible to the market. If the Treasury had to get congressional approval every time it was going to do a large support package of this type, it would almost eviscerate its ability to participate effectively in these operations.

Having said that, I will quickly add that I think there needs to be much more effective communication between the Treasury and Congress. I signed those monthly reports 15 years ago. I assume and understand that those are still coming, but something more is needed in the way of effective interchange with the Committees.

Here, too, one has to be careful about how public such exchanges should be because you are dealing with the private financial markets. If you tip your hand, if you tell everybody what you're doing, you set out a target that makes it more difficult to cope effectively with the speculation.

I'll give you an example.

Thirty-six hours ago I think the U.S. Government, had it wanted to do so, could have totally reversed this decline of the dollar with what's called a bear-squeeze package. The United States and the other G–7 monetary authorities, facing a situation where the dollar had fallen sharply and consistently over a period of several days, where the market was clearly oversold, and out of keeping with the economic fundamentals, could have hit the market with a joint package and driven the dollar back up very sharply.

They did it in the first week of 1988. It's quite feasible.

It turned out they didn't have to do it. Statements by Chairman Alan Greenspan and Bundesbank President Hans Tietmeyer yesterday were enough, along with the fundamentals, to send the dollar shooting back up 3 or 4 percent.

I don't know if that will hold. I don't know if it will continue. You may still need a G–7 intervention package, but I would be quite confident, Mr. Chairman, in saying that in the top drawer of every G–7 finance minister, a contingency plan of that type is ready to go.

But it would be very difficult to carry that out if there had to be congressional action or if limits were put on the amounts of money that our own Government could put into that proposition.

The CHAIRMAN. Mr. Bergsten, I would agree with you if, historically, you could demonstrate this. The fact is, as we look at the historical drawdowns, in no cases has it ever approached anything like this, the biggest drawdown being $1 billion. We are talking here of $20 billion from the Fund.

So, yes, I think it is unprecedented to have the drawdowns of $300 million repaid sometimes the same day, $500 million, the biggest, $1 billion to Mexico.

It is apples and oranges, as I say.

I appreciate what you've said, and I think you've made some very important points about our being tied into foreign currencies as it relates to our own interest as well. I'm not going to just push that aside. I'm very appreciative.

Senator MOSELEY-BRAUN. Mr. Chairman?

The CHAIRMAN. Yes, certainly.

Senator MOSELEY-BRAUN. Thank you. I have a quick question because I have another Committee and another appointment. It's crazy around here at these times.

I think, for me, the real lesson here is one of those things they say in law school about how hard cases make bad law.

Here, we're faced with one of those kinds of hard cases that are likely to make bad law unless we are careful. So I was really intrigued when Mr. Bergsten talked about having recommendations for the future.

Certainly, I would frankly concur that we ought to have something like an Exchange Stabilization Fund around for the rainy day that we may face with regard to our own currency. I would concur with that, given the international nature of all of these things and given, also, the fact of the role that confidence plays in a lot of these decisions that get made.

I was sitting here expecting you to make that next step and talk a little bit about what you see as the kind of international arrangements for the long haul that have to be developed because we can fully expect more, not less, of these situations. We don't know what will happen with regard—everybody held their breath when Mr. Loessing made his $28 billion mistake last week.

You never know what's going to happen in this computer age, when a blip on somebody's screen winds up affecting markets all over the world.

It hasn't happened yet, knock on wood, but we don't know and we don't have, right now, the capacity to come up with arrangements to fix these problems. It's not enough to say, "Well, to heck with them." We can't let them go under when these economies are so tied together.

That was the second point.

What would you recommend in that regard? What should we do for the long term?

Mr. BERGSTEN. This was going to be the third point, as I mentioned at the outset, I was going to address. I appreciate your flagging it.

I was going to underline some of the things that Congressman LaFalce said in his testimony to you earlier this morning.

We do not now have an international mechanism in place to deal with this kind of problem. I, in fact, spelled that out in some detail in one of those recent statements I made that you've agreed to put in the record.

Let me indicate the three basic parts of it.

First, we do not have today an international monetary system that promotes currency stability. Indeed, it promotes currency instability—with freely-fluctuating rates, market bandwagons get rolling that have no relevance to the underlying economics.

In the last few days, the dollar was pushed down way out of relationship to the fundamentally sound underlying U.S. economy. But it's gone the other way, too.

In the middle 1980's, the dollar was pushed sky-high, taking away even our competitive firms' ability to export or even compete against imports in our own market. That's what led to our huge trade deficits. That's what's converted us from the world's largest creditor country to the world's largest debtor in just 2 years.

We have a monetary system in disequilibrium.

There's a great debate among expert economists as to what should replace this system. I support a system that we invented in my institute about 15 years ago called target zones or reference ranges.

They would neither be rigidly fixed exchange rates, which clearly don't work, nor freely flexible exchange rates, which clearly don't work. Those extremes have been tried, and both failed. We need an intermediate system that allows some flexibility for rates, but avoids their getting way out of line with underlying fundamentals.

I won't go into every last detail now, but I assure you it would have a good chance of working. My view is that if we would have had it in place, we wouldn't have had all these recent problems, including the dollar decline. We would have been in much better shape.

We need two other things.

First, we need to focus, in the International Monetary Fund, on a ready response facility to lead in crises like this.

Many of the Members commenting today have quite rightly said that the United States is going to make more enemies than friends in Mexico, if we are the ones who levy the conditions and require high interest rates, pain, and recession. That's why we created the International Monetary Fund 50 years ago, so there would be an international agency, of which the target country is itself a member, that is the bearer of bad news.

That's one of the big roles for the International Monetary Fund. It needs to have a more effective early warning system where it can see problems of this type emerging, enter into the fray, alert the big countries that may have to provide some financial resources later, and help them come in at an earlier period to administer preventative medicine. That is absolutely necessary to avoid more situations like Mexico's.

Finally, the IMF needs to have a financial mechanism in place both to help arrange that preventative adjustment and to come in

if the crises do occur so we, the United States, won't have to do it bilaterally.

Senator MOSELEY-BRAUN. It's own ESF?

Mr. BERGSTEN. Excuse me?

Senator MOSELEY-BRAUN. It's own ESF?

Mr. BERGSTEN. That's right, it's own ESF. As Congressman LaFalce said, "There is a wonderful opportunity to do that 3 months from now."

The G–7 summit, being held in Halifax, Canada, in June, has on its agenda the reform of the international monetary system. At President Clinton's instigation, they put it on the agenda when they met in Naples last July, which was the 50th anniversary of the IMF and World Bank. Now it's time to take a look at bringing the system up to date.

The main way to update it is to deal with this vast increase in both the magnitude of international financial movements and the vast increase in the number of countries—the Mexicos, Argentinas, and Malaysias of this world—that are now subject to these inward and outward movements. It's not just the big industrial countries any more. The wider group is affected.

The IMF needs a new facility to address that issue. The Halifax G–7 summit is the ideal time to put that in place.

Senator MOSELEY-BRAUN. Thank you.

The CHAIRMAN. Dr. Hanke.

OPENING STATEMENT OF STEVE H. HANKE, Ph.D. PROFESSOR OF APPLIED ECONOMICS, JOHNS HOPKINS UNIVERSITY, MARYLAND

Mr. HANKE. Mr. Chairman, with regard to my testimony——

The CHAIRMAN. We'll take your entire testimony as if read in the record.

Mr. HANKE. Thank you. I would like to focus on, since there are just two of you left, your opening remarks and also Senator Moseley-Braun's remark about confidence and credibility, so I can pick up on the themes that you might be interested in.

In your opening remark, I think what you were really driving at is where's the money going to go and will it serve any constructive purpose? So I'll try to just focus on that.

The CHAIRMAN. I wish you had written my opening remarks. You synthesized it very well. Put that down for tomorrow.

[Laughter.]

Mr. HANKE. I think with regard to both of those issues, Mr. Chairman, we're in a situation where Mexico now has a floating exchange rate system. It's a dirty float in the sense that the Bank of Mexico is intervening, trying to buy up and support the pesos. Therefore, that's where part of the money is going. Whether this is a constructive purpose or not, I think is questionable.

However, when you have a floating exchange rate system with a very bad central bank which has a poor history and record, such as the Bank of Mexico, it has no credibility. People don't have confidence in it. The reason for this is a long record that's been bad. In fact, by some reckoning, the Bank of Mexico is ranked about 101 out of 108 in the world. It's one of the worst central banks, historically, that's been on the planet.

So, in that situation with the floating exchange rate, the only thing you can do to try to prop the peso up is to intervene, as they're doing, and use some of this U.S. money to do that. That's one mechanism.

The other mechanism is to have sky-high interest rates, which of course we know they have in Mexico now. That attempts to keep the money attracted in.

The problem with that is we're already seeing rapid increases in defaults in Mexico. This is going to lead to a banking crisis and a collapse of the banking system in the next few weeks, certainly no longer than the next couple of months. This will lead, ultimately, to the nationalization and recapitalization of the banking system in Mexico.

That's another place where the money is going to go. You have to ask yourself, are your constituents going to be wildly enthusiastic about spending U.S. money to prop up the Mexican peso, which is a futile exercise unless they change their monetary regime, and also to support the nationalization of the Mexican banking system after it fails?

I think the answer is probably fairly obvious in both of your cases, but I think that is where we're going. This is the situation we're in. I see no possible change on the horizon because the Mexican politicians are in a rather catatonic state, which they've been in since the crisis began.

Thank you.

The CHAIRMAN. Dr. Hanke, I want to thank you for being so concise and very challenging, to say the least, in terms of what it may possibly be.

Senator Moseley-Braun, would you like to ask any of the panelists any questions?

Senator MOSELEY-BRAUN. I think I've pretty much explored with Mr. Bergsten. Again, Mr. Chairman, my attitude about this is that we've got a bad situation. The question is what do we do about it?

I don't think anybody here is prepared to say that this situation is a good one. The problem for me is—my own view is that it doesn't make a lot of sense to try to make rules and responses in the middle of a crisis like this. That just doesn't really help things.

So, I guess I really don't have any other questions. Mr. Seidman seemed to react to some of the suggestions that Mr. Bergsten had about the IMF's role in terms of future monetary——

Mr. SEIDMAN. I only had one remark. He said that we tried it with a free market, and that didn't work. We tried it with fixed rates and that didn't work. Then he proposed to try it with bands and that doesn't work. Europe has proved that conclusively. So I think we should go back to the drawing board.

Mr. BERGSTEN. No, no. Europe hasn't tried bands. Europe tried narrow fixed rates, and when those created a problem in the fall of 1993, they adopted target zones. They now have a target zone system. The zones are a little wider than I'd like.

Mr. SEIDMAN. It just collapsed again 2 days ago.

Mr. BERGSTEN. No, it did not collapse again.

Mr. HANKE. Fred, if I may. Mexico had a target band. It was called a crawling peg and the thing blew out because your target bands force the central bank to simultaneously manage the pegged

exchange rate and domestic liquidity. These invariably end up being in conflict with one another and you blow yourself out of the target zone.

Mr. BERGSTEN. I told you that economists disagree on this, and you're now seeing evidence of it.

The CHAIRMAN. If I might. Yours was an observation in response to a very legitimate question—what would you do in the future?

I have to tell you, if $3 billion has been spent or drawn down to date for various methodologies, whether it's to buy the peso, support the banks, or eventually a bank take-over by the Mexican government, I think we have a right to know.

I don't understand how it is that Congress wanting to know what is taking place and what this plan is all about could be construed as meddling, intervention, or any of the other characterizations or motives that some people have attributed.

It seems to me, where there is at least $17 billion more that may be expended, we should have an idea or know how it's being spent or loaned, and what the likelihood of success is. And, by the way, what exactly are we attempting to achieve?

I have not, to this date, been able to get that kind of information from a number of officials in the Administration. We have not been able.

I think Senator Bennett—there is no person who has worked harder at attempting to put together a package that would work—has not been able to get any solid answers as to the manner in which this program is being directed.

One thing we do know, and I would ask this of the gentlemen, all three of you.

The situation certainly doesn't look like it is very tranquil or very stable or that whatever our efforts have been to date have brought about any stability in the collapse of the Mexican economy. Not just the peso, but the economy.

What good has been obtained as a result of the intervention? We don't know. Again, it's $3 billion, but we don't know how much is from the IMF. We just don't know.

What positives have you seen to date? What would have taken place had we not intervened?

Is that a logical question? What improvement, if any, have we seen, and what do you believe the difference would have been had we not put up the money that we did?

Mr. HANKE. I've seen very little good. It was almost as if we'd given the Mexicans a sleeping pill. They still haven't clarified their situation with regard to economic policy.

I think, in these cases, just like in trade—my business is actually currency trading. We've been talking about currencies, and currency and commodity trading.

The CHAIRMAN. Did you do pretty good over the last few days?

Mr. HANKE. We've been hanging in there. It's been exciting, Mr. Chairman.

But the point is, there is a point in these things where you cut your losses. I think that's the point we've reached with regard to Mexico.

Let me just give you a little story. It relates to Chicago. That's what I was thinking.

I hedge commodity transactions for grain dealers in Chicago. One of the individuals—it's good business. They're good people.

At any rate, one of the individuals that I had been working with for a number of years ships grain all over the world and used to ship a lot of corn to Mexico.

He stopped, and of course that meant I stopped hedging these shipments going down to Mexico. I asked, "Well, what happened, anyway?" He said, "Well, it's kind of a written rule, when you get into these areas like Mexico or the Middle East, you normally lose about 5 to 10 percent of the shipment with theft and whatnot, but the last train we sent down to Mexico, they stole the whole train." Therefore, he's gotten out of that business.

So I think you have to consider that kind of situation when you're pumping money into, as you referred to it earlier, I think, Mr. Chairman, a black hole.

We don't really know exactly what's going on because the money, of course, is fungible. We know of certain activities that are taking place. They're intervening to support the peso. That helps, as Senator Moseley-Braun said, the investors who took the risk of getting in there. Now they're getting out with perhaps a more favorable deal than would otherwise be the case if that Mexican peso support wasn't coming in.

Also, I think down the road, in a short matter of time, you're going to have the banks going under down there, and they will be intervened by the state, nationalized, and recapitalized.

Now, part of that money, ultimately, is going to come from these funds we're shipping down there.

Senator MOSELEY-BRAUN. Thank you very much.

Mr. BERGSTEN. Mr. Chairman?

The CHAIRMAN. Yes, please.

Mr. BERGSTEN. Your question is quite a legitimate one. What do we have to show for the support?

Unfortunately, there's not much one can show in absolute terms. I would argue, however, that without the support package the Mexican situation, bad as it now is, would have been much worse.

The reason is the following.

The CHAIRMAN. Let me ask you, if you might, would you also put to that—was there an alternative?

I've heard Mr. Seidman testify—I haven't heard Dr. Hanke—about restructuring, saying, as we do when you have a collapse here, "Hey, listen, we're not going to pay you dollar for dollar, plus give you 20 percent interest on the Tesobono."

I have to tell you, as one, I find it absolutely repugnant that the American taxpayers, to whatever extent you want to attribute the Exchange Stabilization Funds, are placing dollars at risk to say to people who invested at a very high risk, we're going to bail you out. I cannot understand that.

That's why it just seems to me, and I kept hearing, "Well, we don't know who the people are." When they come in, you could say, "Well, look, here's your instrument. We're not going to redeem it."

Why wasn't the IMF down there to do this kind of thing?

I can't believe that the geniuses we have, the geniuses that we have throughout the entire economic system, the free market system, could not have been harnessed to help in this manner. Then,

if you say, "Well, let's back it up with some guarantees through the IMF," it makes some sense.

But to have a situation going—and Fred, we don't even know. It's a black hole. We don't know what's happening there.

Senator MOSELEY-BRAUN. Mr. Chairman, if I may. I'm glad you got to that point because I think the record needs to be clarified in one regard, and certainly with Mr. Bergsten here. He's a former Director of the Exchange Stabilization Fund.

It is important to note, and I don't want the record to be confused, that the Exchange Stabilization Fund makes an annual report, and they have. And that they then, on the 30th of every month, have to report to us, and to you, what it is that they've done. They did that on February 22, 1995, with regard to this situation.

This information, under the law, however, is confidential information and it is not to be made available to the public.

Now, with regard——

The CHAIRMAN. I certainly haven't made it available to the public.

Senator MOSELEY-BRAUN. But in terms of the resolution that we are, I think, holding this hearing under, there's a line to be drawn. We're not looking to help individual investors, or help people to influence the market by getting information out into the public domain that the law says should be transmitted between Treasury and you, as the Chairman of this Committee.

The CHAIRMAN. I have never seen, Senator, any confidentiality that was placed upon information that was given to me pursuant to the law. I am not aware of that being a condition.

I am aware of some assertions that are now being made, and we are having Senate legal counsel look into this, as it relates to a question of possibly the Administration claiming Executive Privilege.

If that be the case, and we're trying to ascertain it, we have not really fully received that, but we have sent two letters in which we have indicated that the information to date has not been satisfactory. It has not been complete.

But I was not referring to that. I was referring in terms of what is actually taking place in Mexico.

Senator MOSELEY-BRAUN. OK. We don't have any disagreement on that point.

Let me get to the point that I was going to make.

The CHAIRMAN. Yes.

Senator MOSELEY-BRAUN. We don't have any disagreement on that. I started off my statement saying I concurred that going into this dark alleyway in terms of Mexican finance was a risky thing to do. Mr. Bergsten makes a very important point, a lot of people have, that it was an alleyway we didn't have a choice but to go down. There's no question about that.

I thought it would make sense for this hearing to tell us something about what is the Mexican bank going to do? What are they going to do about the economic——

The CHAIRMAN. I'm hoping that tomorrow——

Senator MOSELEY-BRAUN. What is their plan about? What do they plan to do about interest rates? Where are they headed?

Mr. HANKE. They don't have a plan.

Senator MOSELEY-BRAUN. But that's the point, isn't it? That's what I thought we would be able to talk about, the specifics of this resolution that you keep coming back to. That's the reason I raise this.

The CHAIRMAN. What resolution is that?

Senator MOSELEY-BRAUN. I don't know if it was the resolution you were coming back to. When you made the statement earlier in your comments, you said, "The Administration is not cooperating with us and they're not giving us information."

I just have to take issue with that and say that the report was made just as recently as the 30th of last month.

The CHAIRMAN. Senator?

Senator MOSELEY-BRAUN. And if there is other information, then we get that as a letter and a request, but not a public hearing in which this gets to be a public——

The CHAIRMAN. Senator, this was not the purpose of this hearing, to raise the fact that the Administration has or has not complied with the request of the Committee. Obviously, that is something we are entitled to raise with them and to ask them why they have not complied.

Senator MOSELEY-BRAUN. But you keep saying it over the television. That's my only point.

The CHAIRMAN. No. Oh, no, no, no. I am not alluding to that.

I would like to know what is taking place with the money in Mexico? To what purpose is it being used, and what are the results?

It is the same thing that the Senator has raised. I have not asked Mr. Bergsten to comment on a request that he made, that he may or may not have seen, or the appropriateness of it. He probably hasn't seen it.

As a matter of fact, we're asking Senate legal counsel, and, today, we will probably send a third request.

But the question is what is taking place with the money? How much have they spent? What are they doing?

That is not shrouded with some kind of secrecy. I think even Mr. Bergsten would say we don't want to necessarily advertise all of the things that we may be doing in particularity as it relates to whether we're going to buy Tesobonos or something else. But, certainly, we have a right to know what has taken place to date, what is the strategy, where are we going, and what are the likelihoods of this strategy being successful?

I don't believe it will be. I believe you have what is analogous to a Lenin-style government there which has held out for many years that it is a democracy, just like the Russians used to vote, and their vote didn't count for anything. In most cases down there in Mexico, if the results come out the wrong way, the PRI disregards them. So I don't believe that things have changed.

Having said that, that's this Senator's belief. But I want to know, we may be nobly intended, but what's happening with the money? I think we're entitled to know that.

Senator MOSELEY-BRAUN. Mr. Chairman, again, I don't disagree and we all are in favor of sunshine on this proposition and as much light as we can put on it in terms of information.

My only point to you is with regard to the concurrent resolution that was filed and some of the statements you made earlier, and maybe the statements weren't intended to suggest that.

The CHAIRMAN. I'm not aware of the concurrent resolution that you're talking about.

Senator MOSELEY-BRAUN. Here it is right here. It's yours.

The CHAIRMAN. You're talking about Senator Mack's concurrent resolution as it relates to requesting, and I joined with him, in requesting information, that specific—I think that's very clear. We are entitled to that information.

I did not raise this with any of the witnesses.

Senator MOSELEY-BRAUN. And that's what I just—no, but you keep referring to it.

The CHAIRMAN. No, I do not. I have not raised that. I raise it in response to you.

Senator MOSELEY-BRAUN. Forgive me. I don't want to argue with you because we, I think——

The CHAIRMAN. I think we share a common goal, to find out——

Senator MOSELEY-BRAUN. There's less disagreement here than might—I guess I have to call and take issue with the notion, with the suggestion that I believe you've made. Now, if you say you haven't made it, that's something.

I believe you've made the suggestion that the Administration has been less than forthcoming with the information regarding the Exchange Stabilization Fund.

Again, I'd just point out, they just made the report the law requires and the information that you've requested has been forthcoming. Nobody's trying to hide anything here, other than what the law requires.

The CHAIRMAN. I note the Senator's position and reasonable people can disagree as it relates to whether or not they've given sufficient—and I'm willing to accept your view and we'll find out. I think we are entitled. The American people are entitled to more.

It may be that they have satisfied the requirements. We think they should give us more. When we're talking about this amount of money, I think the American people basically have the right to know—what is the probability of success? What is the goal, number one? What is the goal? What is the probability of success, given all of the conditions that exist there? We haven't asked them what conditions exist.

I mean, my gosh, it does read, as one of my colleagues said, like a novel every day.

The former President's brother arrested for the assassination of a leading candidate.

The Deputy Attorney General found with $6 million in the bank over here, and he's the guy——

Senator MOSELEY-BRAUN. Seven.

The CHAIRMAN. This is a government we are attempting to assist? I have to say, this is a bunch of robber-barons. There's never been a person who's left over there that came out poor. They come out with millions, little functionaries, and we are directing aid to that government that they will be responsible for administering.

We hear testimony—and this isn't the first time—over and over and over again about the inadequacies of their central bank.

We may be giving them dollars, on one hand, but they may be printing pesos that those dollars are now going to buy up, on the other.

Do we know when the last time they printed pesos was? If they are printing pesos, wouldn't it be ridiculous for us to be sending money down to get the value of the peso up, while the same band of robber-barons are printing it up?

That's an incredible transfer of economic wealth. From the American taxpayer down, to who? A handful, a relative handful.

When we talk about prosperity, when we talk about creating opportunity, I don't see any in the devaluation of the dollar. Real economic terms, in terms of what the people are making in Mexico—they've collapsed.

Senator MOSELEY-BRAUN. Mr. Chairman, the funny thing about it, I can't argue the proposition with you on this level because I agreed in forcing it. That was the reason I came down like I did on the original proposition. I didn't think we should be there, either.

But my only point to you is, given that, let us use this opportunity to get as much information on the basics as we can without suggesting that the Administration is trying to be less than forthcoming.

And, no, I understand there was almost an argument up here before, a suggestion that people were trying—there was some skullduggery going on, and that's not fair, either.

The CHAIRMAN. I concurred with—I want you to know, you weren't here—I concurred with Senator Sarbanes and with my colleague, Senator Bennett from Utah. In no way, in no way should this hearing, should there be any implication as it relates to any wrongdoing, any conflict, et cetera.

Senator MOSELEY-BRAUN. Right.

The CHAIRMAN. So I would hope that we wouldn't even bring that up because that just detracts us from—I think the goal that we have, a shared goal—we want the facts, the information.

What is the situation there? What is taking place? Should we be pursuing this course?

I think that is a legitimate role for us to review and undertake, especially in light of the unprecedented use of this fund. This fund has never, Senator, never been used to this extraordinary extent or with these kinds of timelines, generally. Up until this transaction, there's never been a transaction that has exceeded a year, and that's only been with Mexico.

Senator MOSELEY-BRAUN. I don't disagree. The problem is, and I know Mr. Bergsten wants to get a word in edgewise here, the problem is, of course, those who supported it argued that we had our national interest bound up in terms of immigration, in terms of our own currency, in terms of our economy, on a lot of different levels—in terms of American exporters that export from Mexico into the United States to keep our balance of trade. There are all kinds of arguments on how our national interests were bound up in this deal.

I didn't buy it. I didn't agree at the time. Again, that's why I asked the question, Mr. Bergsten, what do we do in the future, because we are tied to the economies of these other countries and we

won't have control, necessarily, over what the brother-in-law of the President does, the Secretary, or the minister of finance and whether or not he's going to run off to Switzerland, buy German marks, or whatever. We don't have control over that stuff and we can't be the banker of last resort for the world.

Clearly, in light of the globalization of the economy, the linking of these currencies, and the interdependence of these economies, something has to get worked out. That's the problem I think we really do need some scholarly guidance on.

Mr. BERGSTEN. If I could interject. This dialog, I think, has tremendously profound implications because what you're really talking about, and Senator Moseley-Braun just made it very explicit, but you were saying the same thing, Mr. Chairman, is that the United States is now so tied up with other countries, is so much a part of an interdependent world economy, that we have to modernize not only the international system, but a lot of our own domestic procedures.

Frankly, the way in which Congress and the Administration interact on these international financial issues is Neanderthal. It does need to be reformed and updated.

You do need more information because these issues are now so much more critical to the average man on the street in the United States.

I would have one cautionary note, however.

A lot of the things you are dealing with have direct impact on market psychology, and thus on market effects themselves. You're the Chairman and a key Member of the Senate Banking Committee. What you say, as you know, is heard all over the world. That affects markets instantaneously, the minute you say it.

It seems to me you have to work out some arrangements in this area, as the Intelligence Committees have worked out in the national security area.

There is a full flow of information from our intelligence community and our defense community to the responsible Committees and Members of Congress, but some parts of it, not all of it, are shared in a way that assures confidentiality and doesn't affect the military situation. In your case, the object is to avoid adversely disrupting markets.

I think you have to work out something analogous. You clearly have to get more information, more disclosure, and more consultation, because you're joint partners in these things. Our practices and procedures, frankly, have not kept up with that.

I want to make one or two other quick comments, if I could. Just a couple of facts.

Mr. Chairman, you talked about the high profits and the bailout of investors. Just to be clear, Tesobonos did not carry high interest rates; the rates were maybe 1 or 2 percentage points higher than the U.S. Treasury's. Tesobonos were dollar-denominated, so there was no exchange risk. But as a result of that, they did not carry high interest rates.

The cetes carried high interest rates, but they were peso-denominated, so the Americans who held those took big losses. The figures have been published. The American mutual funds and pension funds that held Mexican-denominated paper took losses in the

range of 25 to 30 percent. There's no bailout in the sense of avoiding the losses. Investors have already taken them, and that has passed through to a lot of Americans on Main Street who held the pensions, held the mutual fund shares, et cetera. So, I don't think, in that sense, a bailout is really the issue.

Finally, I want to finish——

The CHAIRMAN. Mr. Bergsten, I stand corrected as it relates to the interest rates that were pegged, but I will suggest to you, if you're going to be redeeming paper that is really worth 20 cents, 10 cents, or is valueless for its face value on the market, in the real market, in the free market, that is a bailout, as I know it.

Mr. BERGSTEN. All I'm saying is——

The CHAIRMAN. Again, as it relates to the particulars, as it relates to whatever the percentage interest might be, I'm certainly sure you're much more conversant with what that interest was pegged at.

My point is, though, I want to know why it is that if we're trying to encourage free markets, and we have a free market system, we didn't allow it to work there?

Mr. BERGSTEN. The reason is because we felt letting it purely be resolved by the market——

The CHAIRMAN. Market and work-outs.

Mr. BERGSTEN. —would have had such huge costs for our own economy, it was not in our interest.

That was the only final point I wanted to make.

The CHAIRMAN. Sure.

Mr. BERGSTEN. You asked, what did we gain from this? My answer was, it would have been even worse.

The Mexicans would have had to declare the peso inconvertible and/or put on extensive exchange controls or currency controls and/or unilaterally default on their debt.

Now, some people might say that would have been less bad. That's an honest argument one can have.

I happen to think the spill-over effects from that to our own economy and to other developing countries that had experienced spill-over already from the Mexican problem would have been much worse.

It would have, I think, driven the Mexicans back to the old discredited market intervention model that we all want to avoid. They would have had to put a flat limit on any capital transactions. They probably would have had to institute import controls across the board because they wouldn't have had any money to spend on them. That would have really trashed our exports.

But even more so, they would have reverted back to where they were 15 years ago, before the market-oriented reforms that even their sharpest critics would admit they have put in place over this period. So I'd say it would have been much worse.

The CHAIRMAN. OK.

Mr. BERGSTEN. I can't prove it. That's the dog that did not bark. I can't prove it, but I would certainly argue that would have been the case.

The CHAIRMAN. I think Mr. Seidman has been waiting to comment.

Mr. Seidman. Dr. Hanke. Then we'll take our third panel.

Mr. SEIDMAN. This is, of course, a wonderful argument because the case being made cannot be proven and, therefore, it's difficult to really spend much time on it.

The CHAIRMAN. Sure.

Mr. SEIDMAN. It's hard to believe, however, if you drew trendlines, that any of them could have gone more adversely than what we've just had.

I don't think my friend here, who is an expert in Government and has spent all his life in it, has spent as much time in markets.

The attempt to fool markets and the secrecy reminds me of the Fed, which used to say, "We can't announce what we do because we do it mysteriously."

Now they announce it immediately, and the markets have actually been more stable and have responded better.

I think the basic idea that we are going to do a lot of secret things behind—the markets are much smarter than the bureaucrats who are trying to figure out what to do. As far as the bear-squeeze is concerned, they tried it and failed. No government has been able to keep its currency above its real values for very long.

Senator MOSELEY-BRAUN. The Germans are doing pretty good.

Mr. SEIDMAN. They have kept their currency where it is by appropriate monetary and fiscal policy. If they don't, they'll get hit, too.

My point is, I think an awful lot of—of course, Mr. Bergsten and I have agreed to disagree for the last 25 years, so there's nothing really different about this discussion.

I just think that when you're talking about what we have to do for the future, it's that we have to find a way to let the markets work, just like we have in this country. And that has basically been to use disclosure, to try to exclude from the marketplace those who don't play it straight, who don't disclose, as the Mexicans didn't.

I agree there's a great opportunity for the G–7 to talk about it, but let's not talk about another band on bands. We have tried everything in that area and they failed.

The CHAIRMAN. Dr. Hanke.

Mr. HANKE. Let me move away from economics for just a moment and talk about, really, what the real cost of this looks like beyond the dollars and cents.

We have a tremendous diplomatic cost, in my view, because this really, these conditions and so forth, which of course we're going to put on the sending of money down south of the border, puts us in a situation where we're applying the Roosevelt corollary and the Monroe Doctrine, and we're seen as a bad gringo imperialist, no matter what we do, because of these conditions.

If you think people disliked us down south of the border before all of this, you should go down for a little taste test now.

This has been a completely disastrous policy. In terms of what Senator Moseley-Braun is talking about, we're in the global community concept. This just couldn't be worse from that point of view.

The CHAIRMAN. Senator, do you have any other questions?

Senator MOSELEY-BRAUN. No. I'm fine. Thank you very much, to all of the panel.

The CHAIRMAN. Let me thank all of the panelists for coming in, and for your patience.

We call our last panel, if they're still here, if they've survived. This is the true test of endurance and perspicacity.

Dr. Frankel, Mr. Mueller, Mr. Nader, and Mr. Todd. Your full statements will appear in the record as if read in their entirety.

Please accept our apologies for the lateness of the hour. One thing I do not want to do is exclude any of you from advising this Committee, as it relates to your feelings. Please don't feel inhibited by the time. Let us know what your thoughts are.

Mr. Nader.

OPENING STATEMENT OF RALPH NADER CONSUMER ADVOCATE, WASHINGTON, DC

Mr. NADER. Thank you, Mr. Chairman, for the opportunity to testify today. I'm going to try to avoid redundancy and ask that my full statement be placed in the record.

The CHAIRMAN. So ordered.

Mr. NADER. I want to focus on three themes here. One is what this entire affair has done to our constitutionalism and our relationship between Congress and the Executive Branch.

The second is what should our economic goals be, giving priority to our own domestic market success and our relations with other countries, and third, how does it affect our own democracy in terms of the largest engine that has ever been discovered for economic development, that is, the democratic process.

Congress has increasingly been reduced to an advisory commission to the Executive Branch, whether it's NAFTA or GATT, the fast-track procedures allowing no amendments and very limited debate have further reduced the proper separation of powers.

The general secrecy, and special information flow from the Executive Branch to certain Members of Congress, have reduced the proper separation of powers.

And the constant crying of wolf by the Executive Branch every time some Senator or Representative wants to raise some legitimate questions is becoming a little tiring.

Congress cannot possibly be engaged in policymaking under the Constitution if its principal impact in this area is the invitation to Alan Greenspan to come to testify before the cameras, with the resultant impact on the markets.

I think Congress has a bigger function there, and it will soon have an opportunity to exercise that function because, unless I'm mistaken, it won't be long before the Clinton Administration will have to come to Congress and ask for the replenishment of the $20 billion in the Exchange Stabilization Fund, and a very major contribution to the International Monetary Fund which has now been extraordinarily depleted through the biggest single extension of credit, et cetera, to a country in its history.

You'll notice they are just cutting a deal with Russia for $6 billion, which was considered big money until a few months ago. Now we have a $17 billion plus package by the IMF heading toward Mexico.

What is lost in all of this is why Members of Congress feel either intimidated or passive in reasserting their constitutional role in order to develop a policy here. They do represent taxpayers, we would hope, they do represent workers, we hope, and they do rep-

resent consumers, we would hope. These are the touchstones of any future policy and oversight.

Because these areas are very specialized and have a lot of technical jargon, it's often the case that the witnesses and the counselors tend to be myopic. They tend to be myopic because of the abstraction to which they have driven the subject.

When we're talking about the United States and Mexico, we're talking about workers, consumers, taxpayers, and we're talking about democracy. There's almost no mention of the presence of the workers in Mexico, who are suffering and have been suffering for almost 15 years. There has been a steady decline in their standard of living which will become much worse with greater unemployment and greater pressures to drive the peasants off their lands, which is already occurring.

And, of course, there will be increased pressure for illegal immigration in this country.

So I think we have to be very clear, what are the goals of the Clinton Administration and how can Congress contribute to them?

Are they short-term goals to deal with a regime's cash-flow, an economy which the Clinton people keep saying is fundamentally sound?

This, to me, is a devaluation of the word "fundamental."

The Mexican political economy is basically a lawless, criminal operation run by a dictatorial regime in cahoots with oligarchs who keep getting richer through privatization and through other transfers of public wealth to their coffers as they move their money abroad.

At the bottom, of course, is the vast population in Mexico, the impoverished peasants and the workers, who do not have civil liberties, civil rights, or any kind of ability to shape the future of their country.

Why are we becoming entangled, as a Nation, with this kind of dictatorial criminal regime?

If we are going to become more and more entangled, we will be driven downward, whether in terms of a bailout package, in terms of our democratic processes here in Washington, or in terms of unfairly burdening workers and consumers in this country with the bill.

That is why the Administration appears to be in such disarray. It has no goals, it has no purpose to try to deal with this problem, and it doesn't want to disengage from Mexico.

It's become like taffy, a taffy relationship, and the U.S. Treasury and the Federal Reserve are putting money on a sinking ship south of the border.

This is an illustration of the folly of NAFTA, which established a greater framework of entanglement with the Mexico dictatorial regime, and which is now turning into a monster reversal of what its supporters promised it would do. Growing trade deficits, growing job losses, growing hemorrhaging of our own liquid assets, like the Exchange Stabilization Fund, and the growing lack of realization by the Clinton Administration, Mickey Kantor, and Robert Rubin, to pay attention to the reality on the ground.

In conclusion, and I know we can discuss this more later on, let me just say this.

The price to be paid for congressional indifference to the absence of any administrative due process in the making of these governmental policies by the Executive Branch is one that will be paid in ever more arcane ways by the taxpayer.

One price is that private privilege becomes public policy through secret government that is unaccountable and is afflicted by the institutional conflicts of interest perpetrated by Government officials on leave from their financial posts in New York.

Remember, Mr. Chairman, I said institutional conflict of interest, which is far more serious than any possibility of a few personal stock funds or whatever.

What is happening here is that Wall Street officials are running the Federal Government in this area. They don't have the sensitivity, the knowledge, or the experience necessary to reflect our economic and democratic policies in the best light, vis-a-vis the Mexican regime.

Another price is the increasing politicization of the Federal Reserve by its leaders, especially Alan Greenspan, whose vigorous involvement with the Administration to gain congressional support for the bailout has dismayed at least one of Mr. Greenspan's predecessors.

This is a very serious point. I have never, in all my years in Washington, seen a more vigorous crossing of the line from the so-called independence of the Federal Reserve, which they keep telling Congress is the reason why you should not appropriate budget for the Federal Reserve. You shouldn't have the GAO audit the Federal Reserve.

The crossing of that line into a blatant daily collaboration with the political appointees of this Administration to lobby this bailout through Congress, which fortunately they did not succeed in doing, but, unfortunately, they did develop a unilateral Executive Authority of dubious legality in exercising the bailout package that was announced in late January.

But the largest price will be paid by the spreading revulsion among the American people to the imperial demand that wealthy people and institutions that do not play by the rules get bailed out by working people who do, and to boot, a dictatorial regime gets a bailout for doing the wrong things to its own people as well as to its relationship with the United States.

If there are any Members of Congress that have the slightest doubt that this deep sense of unfairness is widespread and mounting, they should turn on the more evenhanded talk radio shows or directly sample opinions back home.

Congress must draw a line at this Executive Branch usurpation of power and the Executive's negligent giveaway of political control to both unaccountable corporations and private financial institutions, as well as a grossly unaccountable dictatorial regime in Mexico.

The key word here is discipline. What progressive standards of discipline were attached to these loans, if only to reduce the likelihood of worse situations from occurring in the near future?

They want high interest rates as a condition, they want the recycling of the Pemex dollars as a surety, and they want other so-called prudent government spending by the Mexico regime.

This is going to throw Mexico into a depression. So they've gotten themselves in a situation where they may be coming back and saying they have to put more good money after bad.

It used to be, Mr. Chairman, that bailouts of banks whose loans and speculations soured were justified as protecting depositors. Now, for the first time in our history, we have bailouts directed at protecting investors who gambled and lost. Moreover, the scale is much larger, as you pointed out, as the abyss of undisciplined official and private greed in Mexico and Wall Street becomes deeper and obligates more the U.S. taxpayer.

Has Mexico now become the welfare ward of the United States taxpayer?

Has Mexico joined the list of big banks deemed too big to fail?

What are the portents of such a burden on American workers from the devalued peso's sizable lowering of comparative wages of Mexican labor?

This proposed loan guarantee cannot deal with the deep structural problems of the Mexican economy as if Mexican people matter. The problems are a result of a dictatorial oligarchy, that knows few self-restraints, and a binge of credit expansion that is coming due for domestic banks and businesses in that country.

To put it symbolically, if Wall Street expects to be able to stampede Washington any time the Street's risks materialize in a foreign country, these risks will be taken every few years, again and again, and on an ever-larger scale.

Insiders who counsel prudence will be waved aside in the rush to speculate in excess, and the Washington corporate welfare system will continue to mushroom.

Members of Congress are big on demanding that welfare for the poor require work fare, discipline, training, and even 2-year limitations.

Is Congress going to burden middle class taxpayers with a big new welfare ward in the form of a Mexican regime that exploits its people, suppresses their rights as workers, consumers, and citizens, and favors a tiny group of immensely wealthy oligarchs who are not even asked to help bail out their own government?

The multibillionaire oligarchs who have their money stashed away in hard currency abroad are not even being asked by their government, or our Government, to help bail out the government that made them so rich.

There is such an inequity to both the Mexican and American people of transferring the full faith and credit of the U.S. Government to this transborder frenzy of speculative investment and reckless borrowing instead of pursuing more deliberate and intelligent policies that would foresee and forestall a crumbling future. Just consider that inequity.

Those policies should be considered by several congressional committees as soon as possible under the rubric "economics as if people mattered."

Any attempt to expand NAFTA and bring on more oligarchic nations, more oligarchic burdens, or more oligarchic domino theories by this Executive Branch should be blocked steadfastly by a resurgent Congress mindful of its constitutional obligations and separation of powers.

In a final, non-partisan note, Mr. Chairman, I might say that if the Republicans were in charge of the White House, as the Democrats are now, so common is the belief and ideology in secrecy and freezing out Congress on these issues of foreign trade and investment, that I think they would have been behaving exactly the same way as the present Clinton Administration, which makes your cause so important on a constitutional and non-partisan basis to reassert the position of Congress and the sunlight that it can generate, as well as the subpoenas that it can file, to get to the bottom of this before this becomes a downward-pulling trade and investment process world-wide via NAFTA and GATT.

We want pull-up trade and investment agreements that pull up other countries to our level, not to get engaged in pull-down trade agreements and investments that pull down our standard of living to lower levels abroad.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Nader, for a very, very compelling presentation. And it does get somewhat lonely, as you can see.

Mr. Mueller.

OPENING STATEMENT OF JOHN MUELLER VICE PRESIDENT AND CHIEF ECONOMIST, LEHRMAN BELL MUELLER CANNON, INC., ARLINGTON, VA

Mr. MUELLER. Thank you, Mr. Chairman. I appreciate your invitation to testify before the Senate Banking Committee. On a personal note, I was speaking with my partner, Louis Lehrman, on the phone a few minutes ago, and he asked me to send you his personal regards.

I'd also like to add that you were not incorrect in your statement of the interest rates paid on dollar index bonds in Mexico. Although they are lower than the peso-denominated bonds, back in 1988 they were yielding an average of 30 percent in dollar terms.

With your permission, I'd like to submit for the record two recent papers by our firm concerning the effects of the bailout in Mexico. The papers examine the crisis, largely from Mexico's point of view, and explain why Mexico is unlikely to meet any of the targets outlined in its agreements with the U.S. Treasury. For example, the inflation rate is liable to be two or even three times the official forecast of 19 percent for 1995. Moreover, the bailout itself delays, rather than promotes, the adjustments which we're trying to achieve in Mexico. This has serious implications for the future stability of the peso.

In my statement today, however, I would like to consider the impact of the Mexican crisis on our own currency, the U.S. dollar. As you know, since the Mexican crisis began last December, the peso has dropped more than 50 percent, from 3.5 to—I understand today it's trading at 7.85 pesos to the dollar. The accompanying chart over here shows that the weakness of the peso against the dollar has been mirrored, almost on a daily basis, by the weakness of the dollar against other major currencies, such as the Deutschemark. Before Christmas, as you can see, the dollar was worth 1.58 Deutschemarks. Yesterday it fell below 1.35 before recovering, a drop of 15 percent.

It would be a mistake to oversimplify this relationship which, after all, involves the whole economies and financial markets of our two countries and, in fact, the rest of the world. But I must disagree with Mr. Bergsten in his remarks, and say that the Mexican crisis is almost certainly the biggest single factor in explaining the dollar's recent decline. Not only does the fall of the peso, as my submitted testimony points out, shift Mexico's current account deficit temporarily to the United States; the bailout itself forces an easier U.S. monetary policy than would otherwise occur. I would like to explain why this is so.

The U.S. monetary authorities are, in effect, loaning dollars to the Mexican monetary authorities. We give dollar IOU's and receive peso IOU's in return. Until Mexico repays these loans, which will take, as you pointed out, 5 to 10 years, this amounts, in effect, to issuing new dollars backed by pesos.

This leads to the curious result that, while other currencies, including the yen and the Deutschemark, are backed by the dollar which is the chief reserve currency, the dollar is now being backed in part by the Mexican peso.

The process can expand our own money supply in one of two ways, depending on whether it's financed by the Federal Reserve or the Treasury's Exchange Stabilization Fund, which share our Nation's $40 billion official reserve of foreign currencies between them.

Under our laws, the Federal Reserve may purchase peso assets in just about any amount it pleases. But when this happens, it equally expands Federal Reserve liabilities, which constitute the currency and bank reserves, or so-called high-powered money, of the United States. Last week, the Federal Reserve's foreign currency holdings had increased about $3 billion since early December. There is some evidence that the Federal Reserve had first provided more than this, but then transferred the loans to the Treasury.

In theory, this expansion of money could be offset by the Federal Reserve selling an equal amount of U.S. Treasury securities. However, since mid-December, the U.S. monetary base—that's another name for our high-powered money—has expanded by more than $8 billion, even taking seasonal variations and reserve requirements into account.

This brings us to the other process by which the bailout affects U.S. monetary policy. Back in December, the Treasury held, in its Exchange Stabilization Fund, about $20 billion worth of foreign currencies, almost entirely in Deutschemarks. According to Administration officials, the Mexican bailout was not supposed to be financed by reducing the amount of yen and Deutschemarks. In that case, how can the Mexican bailout be financed?

In essence, the Treasury borrows by issuing U.S. Treasury bills, and then delivers the proceeds to Mexico, receiving peso IOU's in return.

This extra U.S. Treasury borrowing would ordinarily tend to drive up short-term interest rates in this country, but with the Federal Reserve targeting the Federal Funds rate, currently at 6 percent, and with the Treasury bill rate almost exactly at the Federal Funds rate, what happens instead is that all the extra Treasury debt is purchased by the Federal Reserve, expanding the sup-

ply of currency and commercial bank reserves. This excess money quickly finds it way to foreign exchange markets, increasing the supply of dollars offered against Deutschemarks and yen. This depresses the dollar against other major currencies.

The point, then, is that whether or not the bailout is financed directly by the Federal Reserve, it can force an effective easing of U.S. monetary policy, unless the Federal Reserve deliberately raises interest rates instead of the additional demand for credit. But the Federal Reserve has chosen not to do so.

I'm not qualified to say whether using the Exchange Stabilization Fund to support the peso is legal, the discussion that we heard this morning.

Mr. Bergsten referred to the original legislative intent of the law 60 years ago. I was reading that earlier, and the authorization begins by saying that it's "for the purpose of stabilizing the exchange value of the dollar." Then it proceeds to the authorizing language.

But it is quite clear that this represents a significant change in policy by the Federal Reserve and the Treasury. The most recent official report on Treasury and Federal Reserve Foreign Exchange Operations noted, as it usually does, that, "The U.S. monetary authorities regularly invest their foreign currency balances in a variety of instruments that yield market-related rates of return and have a high degree of liquidity and credit quality." That's from the Federal Reserve Bulletin of last December. It certainly cannot be said that the loans to Mexico have a high degree of liquidity. Moreover, the current crisis was triggered largely by the fact that the Mexican government was about to default on its debts.

There are some fundamental reasons which suggest that the dollar ought to be bottoming against the other major currencies and beginning to strengthen a bit, but the point of my remarks is that, right now, it's clear that the major cause of the recent dollar weakness is the situation in Mexico, and especially the bailout of the peso.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Mueller.

Dr. Frankel.

OPENING STATEMENT OF JEFFREY A. FRANKEL, Ph.D. SENIOR FELLOW, INSTITUTE FOR INTERNATIONAL ECONOMICS, PROFESSOR OF ECONOMICS, UNIVERSITY OF CALIFORNIA, BERKELEY

Mr. FRANKEL. Thank you for the invitation to testify, Mr. Chairman.

The CHAIRMAN. Thank you for your patience.

I want to thank the entire panel. You've exhibited an extraordinary degree of patience and you're probably the panel that, at least as it relates to expertise, taking away nothing from the other panels, are second to none. I thank you.

Mr. FRANKEL. We appreciate your staying here.

I believe you have the full text of my statement.

The CHAIRMAN. We do. That will be included in the record as if read in its entirety.

Mr. FRANKEL. I plan to concentrate my remarks on the origin of the peso crisis, if that would be all right.

The CHAIRMAN. That would be excellent.

Mr. FRANKEL. By now, many commentators have laid responsibility for the Mexican crisis at the doorstep of the Clinton Administration. The opinion columns have appeared in the Washington Post, the Wall Street Journal, the Washington Times, and many other places. A mistake that the Mexican government made in 1994 regarding the peso was "a massive miscalculation," a mistake so egregious that is should have been obvious to all. It was so egregious that the U.S. Government should have acted to force a different peso policy on our neighbors. But Clinton Treasury officials actually encouraged the Mexicans in their folly. This "may prove to be the worst mistake so far of the Clinton Presidency," or "the worst foreign policy blunder of this Administration." I have in the footnotes the op ed pieces I'm referring to. The American taxpayer and the Mexican citizen, we are told, are now paying the cost. Congressmen are demanding from the Administration that someone should be held accountable for its obvious blunder.

There's just one problem. Approximately half of these commentators claim that the mistake Mexico made was to have devalued the peso. But the mistake that the other half of the commentators have in mind is that the Mexicans failed to devalue the peso earlier. Some players may be keeping their options open as to which mistake they want to pin on the Administration.

The first camp believes that devaluation is a medicine that obviously doesn't work, because it merely raises wages and prices proportionately. They believe that devaluations are so wanton and so unusual that when they occur, there must have been a conspiracy on the part of a small camp of devaluationists, for example in the U.S. Treasury or the International Monetary Fund, to foist this discredited medicine on the gullible country in question. They accuse the Clintonites and the IMF of aiding and abetting the peso travesty.

The second camp believes that the error was in not devaluing earlier. The growing Mexican trade deficit made it obvious in 1994 that the country would have to devalue eventually, and the problem was made worse by postponing it. This second camp of critics either accuse the authorities of being asleep at the switch, or they hint at a conspiracy between the Clinton Administration and the Salinas Administration to postpone the devaluation until after the NAFTA vote in the United States and after the Presidential election in Mexico. One variant of this view——

The CHAIRMAN. If I might?

Would that be very unrealistic? Given the proposal that you have read, the dynamics of American politics, and the dynamics of democracies, it would seem to me that it would not be a far reach to come to that conclusion.

I want you to continue. I'm talking about your last theory, that the bad news and the medicine that would have to be given to the ailing patient was withheld because of local circumstances, an election.

Have we not seen that replayed many, many times in our own State and local, as well as national, agendas?

Mr. FRANKEL. Yes. I do list in my testimony a number of reasons why it is understandable that the Mexicans were reluctant to de-

value, and after five other reasons, I say that if the Salinas Administration also succumbed to the temptation to postpone unpleasant economic adjustments for political reasons, they would hardly be the first politicians to commit this sin.

The CHAIRMAN. OK.

Mr. FRANKEL. I agree.

The CHAIRMAN. I didn't mean to interrupt your flow, so please continue.

Mr. FRANKEL. That's quite all right.

It is important to understand that there is no simple universal answer to the question whether or not countries like Mexico should maintain a fixed exchange rate. Tradeoffs are inevitable in the choice of exchange rate regime. Furthermore, the question cannot be resolved by a belief in free markets or an aversion to government intervention, no matter the intensity of one's beliefs.

And we economists do believe in free markets.

On the one hand, free-marketeers, like Professor Robert Mundell or Bush Administration official Jack Kemp, will tell you that governments should get out of the business of manipulating the currency, and by this they mean that the government should keep the exchange rate constant or opposed to devaluations because they can lead to inflation. On the other hand, others, like Professor Milton Friedman or Reagan Administration official Beryl Sprinkel, are equally fervent in their beliefs in free markets. They, too, believe that governments should get out of the business of manipulating their currencies, but for them this means that governments should let the currency float, to be freely determined in the marketplace.

Al Meltzer argued this viewpoint here earlier today.

They think that the market is the best judge of the appropriate value of the currency, and that when the government intervenes to prop it up, it really prolongs balance of payments deficits and makes the ultimate adjustment more difficult.

Who's right?

No universal answer is possible. Whether the advantages of a fixed exchange rate in a particular case outweigh the disadvantages depends very much on the specifics of that case.

In the case of Mexico, my own view is that the policy of anchoring the peso to the dollar in 1988 to bring down inflation was a very good policy initially, but that the dangers of overvaluation grew over time. The primary reason for this is that, with some residual inertia remaining in Mexican inflation, Mexican goods gradually lost competitiveness on world markets. The trade deficit was the result.

The economic dangers came to outweigh the economic benefits perhaps around March or April of last year. Capital was no longer pouring into the country to finance the trade deficit as it had in 1993. Rather, money had begun to flee, largely as a result of the assassination of Presidential candidate Luis Colosio, in combination with increases in U.S. interest rates. In retrospect, this probably would have been a better time to devalue the peso than on December 20, the date when the devaluation actually occurred.

This is where I give some reasons why one can understand why the Mexicans might be reluctant to, but, nevertheless, I do come down on the side, as it sounds like you do, arguing that, in the in-

terest of economics, it would have been better to abandon the exchange rate commitment earlier in the year, rather than later. In any case, by December 20, the country was about to run out of dollar reserves with which to buy unwanted pesos, so that there was no longer any choice but to let the value of the peso fall, whether by devaluation or by downward float.

There's literally nothing else they could have done.

In my view, it is particularly impractical to talk now of going back to 3.5 pesos to the dollar. Given current prices in Mexico, its goods would be very uncompetitive on world markets at that exchange rate, and its large trade deficit would grow even larger. Those who argue in favor of going back to 3.5 apparently believe that Mexican nominal wages and prices would fall by 50 percent immediately after the peso was revalued. If that happened, it is true that Mexico would maintain competitiveness on world markets, which is what must happen if the country is to earn the dollars to pay back its debt, but anyone who thinks that wages and prices would in fact behave this way is, in my view, living in a dream world.

Furthermore, the Banco de Mexico does not have the reserves necessary to back up such a high value for the currency. If it tried to return to the old value of 3.5, it would certainly be forced to abandon the peg even more quickly than it did in December, as speculators rushed to sell pesos for dollars. These speculators would not wait around to see if Mexican workers and firms responded to that revaluation by cutting wages and prices by 50 percent. They would sell. Surely American taxpayers, who are already concerned that the January 31 support program will end up costing them money, would be very upset if these financial resources were, in the space of a few hours or a few days, converted into profits for speculators.

In my view, an exchange rate peg at 3.5 would fail regardless how high the Mexicans raised interest rates, and regardless how many bankruptcies among banks and firms they were prepared to tolerate. Extraordinarily high interest rates did not save Sweden or the United Kingdom from hemorrhaging reserves in the European currency crisis of September 1992.

I'm near the end here. I understand the hour is late.

I have no independent knowledge as to whether the Administration pushed the Mexicans in one direction, or the other, or neither in 1994. The most recent press reports suggest that Treasury officials, throughout the fall, did in fact recommend devaluation to their Mexican counterparts.

My own view on the merits of various policies, or the views of other economists, are irrelevant, however, to the point I wish to emphasize here. The point is that everyone likes to cast blame afterwards. The uninitiated newspaper reader would be likely to conclude that commentators unanimously consider the Clinton Treasury to have been negligent and incompetent. Only the careful reader will discern that half of the opinion columns claim that the negligence lay in the mistake of encouraging the Mexicans to devalue, while the other half claim that the negligence consisted of encouraging them to delay the devaluation.

From the viewpoint of a scholar of history and economics, it would be interesting to know what, if anything, Washington officials told the Mexicans before December. I understand that congressional investigators are seeking to discover this. What did they know and when did they know it?

When the answers become public, whatever they are, some observers will then say that the Clinton Treasury made an obvious blunder. I respectfully propose that those who think that the right policy was obvious are obligated to say what they believe Treasury should have done before they get the documentation on what Treasury actually did. Do they believe that the Mexicans should have been encouraged to devalue earlier, or do they believe that they should have been discouraged from devaluing at all?

The CHAIRMAN. I have no idea. I have no idea at all. But I will pose to you a question.

Shouldn't we be told precisely what they're doing with the money, what the results are, and how this proposal, which is a massive, massive infusion of capital that comes directly and indirectly from American taxpayers, is going to be used?

I don't know whether or not they were told to devalue early or not early; it's happened, it's out. The worst is done.

Now, do we pack more bullion on the remaining horses that are in the stable, the taxpayers' bullion, to carry it to wherever south of the border?

I've seen $3 billion go. I don't know how much in funds of the IMF have gone. We've been told $3 billion.

I have to suggest to you, given the instability and very unscientific nature of that government and what is taking place down there, I don't know how we could bet in good conscience. I think it was one heck of a bet. I didn't know this Government was in this business. You talk about casinos, you talk about making the hardest point there is, this is like a casino. You want to bet, in 5 to 10 years, they're going to pay us back.

And they collateralized it with the oil revenue supposedly. Are we going to send American troops down there to get the oil, or to cease the dollars when they begin to sell it or whatever?

That may be a pessimistic view, but what are we told to counter that? What are the arguments? What are the safeguards?

I hear about tranches. I didn't know whether it was a tranche or a trunch. I doubt the American public knows. I doubt that many in Congress know. Of course, we're not the most intelligent people. We don't know what anything is, but I don't know how this operates.

What conditions will they implement? Don't tell me we'll agree to a condition. People agree to everything, and then they do what they want. Yeah, yeah, we'll do it.

When I come to the bank to get money, I'll promise them the world, right? But how do we get implementation? And, by the way, are the conditions reasonable?

When I see the raising of interest rates to extraordinary heights, where businesses and people can't pay their mortgage, I'm saying how does that, in the fullness of the context of what we're attempting to do, help the situation?

It is mindboggling to me. These are, admittedly, almost superficial questions. We don't get into the details on anything. We're trying to get even broad outlines, and no one has come forth to answer these questions. And when we pose them—and I understand this is not your problem, this is mine—we're treated like some vicious enemy.

I didn't suggest any wrongdoing on anyone's part. Let the record reflect that. But I do question judgments that have been made.

Do we acquiesce and permit the further flow of billions of dollars without asking some fundamental questions and getting the answers to them that reasonable people would want to know? If this was your money, and it is indirectly because it's spread out among so many, I think you would want to know what are the chances of repayment, what are the risks involved, and how do you intend, specifically, to bring about this change.

By the way, they have a bunch of robber-barons down there. How are you going to get this conduct?

We seem to be dealing in almost a mythical sense that if there was a government and if there were ministries who could implement reasonable conditions and reasonable steps, it would be implemented and that it would have an impact.

Are we really suggesting that we can sign off on the group that is down there or the group that may take control at any time, that this is going to be the case?

I am very doubtful, very, very doubtful about that.

Mr. Todd.

OPENING STATEMENT OF WALKER F. TODD OF COUNSEL, BUCKINGHAM, DOOLITTLE & BURROUGHS, CLEVELAND, OH

Mr. TODD. Thank you, Senator. I want to commend you for having this hearing and for your interest in this subject.

I would like to submit my statement for the record with a few attachments thereto that I faxed to your staff last night.

I think the role that I should play is to clean up some of the legal and constitutional issues as well as I can, since I think I'm the only lawyer on the panel. [Note: Mr. Nader also is a lawyer.]

Those who are familiar with my background and my work know that I worked as both a lawyer and an economist at the Federal Reserve System for about 20 years, leaving in the fall of 1994 to join a private firm in Cleveland, Buckingham, Doolittle, & Burroughs, where I now practice.

One of the interests I acquired during my term at the Fed was foreign exchange intervention. This was spurred by Mr. Lee Hoskins, then the President of the Federal Reserve Bank of Cleveland. He's now the President of Huntington National Bank in Columbus.

You might give him a call. He would make an interesting witness, too.

Beginning around 1988, the Federal Open Market Committee (FOMC) confronted a round of requests for extraordinary assistance to Mexico in that election year that is well worth the attention of your Committee staff to examine.

The FOMC transcripts covering 1988 have now been released by the Board of Governors. They are now public records. You may go

to the Board and get them. You should pay particular attention to the conference call of October 17, 1988.

The entire transcript deals with an extraordinary loan that Mexico requested. You should also see the discussion in the November 1, 1988 FOMC transcript, particularly the passages on pages 19 to 23, where you will find several of the same Federal Reserve Board staff people who were involved in the current crisis making recommendations and representations to the FOMC members that are essentially the same set of representations that have been made in the most recent round.

The CHAIRMAN. Can I ask you to suspend for just 2 minutes? I want to hear all your testimony because you've been so patient. I'll be right back.

[Recess.]

The CHAIRMAN. Mr. Todd, please continue.

Mr. TODD. In any event, around 1991, I came to write a long article on the history of the Exchange Stabilization Fund. The initial impetus was that my superiors at the Federal Reserve asked for it as part of a system study that was going on regarding the history of the operations of the Exchange Stabilization Fund and of the Federal Reserve foreign exchange market interventions generally.

I think you and your staff will find that a very useful guide to many of the legal and constitutional as well as some of the economic issues involved in the background of the use of the Exchange Stabilization Fund.

If I can shift to what could have been done, briefly, on the legal and constitutional side as the Mexican crisis arose in 1994. The thing that stands out—I want to endorse the constitutional analysis that Mr. Nader made in his presentation—the thing that stands out is the extent to which the Executive Branch has usurped functions that are properly those of the Legislative Branch and, in this case, the control of the value of money is properly a legislative function, not a function of the Executive Branch.

There have been passed several, in my opinion, unfortunate Emergency Powers Acts in this century for one reason or another, typically in war time. When the war ends, unfortunately, those Emergency Powers Acts remain on the statute books and get invoked at times like these. Even worse yet, the Executive Branch begins to issue Executive Orders, ordering the Fed to do this, ordering the Fed to do that, without explicitly invoking the Economic Emergency Powers statute that is relevant to the matter at hand. That seems to have been the case here.

As I understand it, this whole transaction has transpired from late January to the present moment under Executive Orders that don't necessarily refer to a particular Emergency Power Statute.

In 1978, just before the Iranian crisis arose, the International Economic Emergency Powers Act was enacted. That did give, in fact, the President, any President, the authority to do what I think Mr. Meltzer and Mr. Seidman were suggesting could have been done this morning.

That is, if the President had wanted to, he could have formally declared the relevant emergency, ordered all Mexican assets marshaled at the Treasury Department that are within the jurisdiction of the United States, and ordered all persons holding claims on

Mexico to submit those claims to the Treasury, and the Treasury would just appoint a tribunal to start sorting things out.

Meanwhile, if you would wish to contribute money either from the Treasury or the IMF into Mexico for an honorable purpose, we could have adopted Professor Hanke's currency board plan, for example, and committed some money to start up a currency board stabilizing the peso, enabling the Mexican economy to grow with comparatively low interest rates. That would have been a far better outcome than the one we see now.

Picking up on a point you made, the absence of a list of creditors, a creditor's list would be an essential element of any bankruptcy reorganization, any debt restructuring in an American bank, if you were dealing with domestic borrowers. I think Congress should insist on nothing less in this case. Money should not be flowing into the exclusive control of the Banco de Mexico unless the Mexican authorities tender to the U.S. Government, or its authorized representatives, an exhaustive list of the creditors to whom Mexico owes money.

One of the disturbing things during the month of January was that the Treasury would present Congress a reason for putting up a little more cash to help out because we had this defined problem, and then the following week an entirely new class of creditors, apparently never discussed, would emerge from the woodwork. The Mexican banking system, itself, for example; you would learn that our money is being used to enable Mexican banks that are insolvent to remain open and honor some of their obligations.

There has not yet been formal discussion, as far as I know, of the Euronotes, the Eurobonds that were issued by Mexican borrowers in the last 5 years, since around 1990. By my reckoning, there's at least $29 billion of Eurobonds or Euronotes outstanding.

This is a combination of obligations of the public and private sectors in Mexico, and they have debt service requirements attached, and it's just not clear whether the monies that the U.S. Government is providing will be used to pay off these private sector claims.

The CHAIRMAN. Just a quick question to pose. Tomorrow I hope you're listening because I don't want to be the only ninny listening. Then, when it comes time to pose some of these questions—because that's a good question, isn't it?

Dr. Frankel, isn't that a good question? Are we buying Eurodollars, sir, or Euronotes?

Would that be something you would want your elected representatives or the Treasury to know?

Mr. FRANKEL. The issue of information is something I don't know how to get into. There's been a lot of discussion here.

The CHAIRMAN. Let me ask you this question, and it may be unfair, but it's so fundamental to the issue and I didn't know about these Eurobonds.

Should we know, as it relates to this attempt to recapitalize, it seems to me, Mexico and its economic system, if part of that is to repurchase or to allow these notes, maybe these bonds, as they come due, and the amount that they are for, et cetera, and if we are paying them off dollar for dollar?

If that $29 billion is something that we're going to help facilitate, whether it's repayment or restructure, et cetera, shouldn't we know that?

Mr. FRANKEL. I think, perhaps, I can help a little bit on the question that keeps coming up as to whether this money is going to help the Mexican banking system, whether it's going to support the peso.

The CHAIRMAN. I just want to know about this Eurobond issue. Should we know that? Should the Treasury know it?

Mr. FRANKEL. What the specific obligations of Mexico are?

The CHAIRMAN. No. Whether or not the dollars that we are going to be making available, the combination of dollars, $47 billion that will be used as a guarantee or will be there, whether or not any sum or a portion of it will be utilized as it relates to repurchasing or meeting the obligations, when they come due, of these Eurobonds? Should we know that, if that's part of the plan?

Mr. FRANKEL. The Senate is entitled to a full accounting on how this——

The CHAIRMAN. Suppose you're the Secretary of the Treasury, and I ask—I'm getting ready to ask this tomorrow—Mr. Secretary, in part of the plan, is there any plan to repurchase or to meet those obligations of Eurobonds?

Mr. FRANKEL. I'll have to work on my Rubin imitation, but——

The CHAIRMAN. Would that be an appropriate question?

Mr. FRANKEL. That would certainly be an appropriate question.

The CHAIRMAN. That's all I wanted to know.

Mr. FRANKEL. But let me make two points.

First, is one that Fred Bergsten made before. The whole point of this is not to commit ahead of time, as to exactly what should be used.

The CHAIRMAN. Isn't that what Mr. Todd brought up? In his testimony—I was listening, and I don't know if these guys were because they were talking. I don't know where the rest of the staff went.

That does bother me, but he said it would appear that there may be a whole new class of creditors who are coming forward, coming out of the woodwork. I think I'm paraphrasing him. They are now coming out of the woodwork. Before, maybe we didn't see them as getting much of anything, but now they're beginning to think about the American guarantees, and they're running up and saying, "Hey, what about me, I'm here, I'm in line, bail me out."

It just seems to me, this is the first I've heard. I will tell you this. To the extent that I have had any dealings with the Mexican officials, the Mexican Chief of Staff was the most forthcoming individual that I dealt with in this Administration or any other place, and he convinced me of the absurdity of putting up what is an insignificant amount of money, which is very significant, but insignificant to deal with this problem.

That $47-some-odd billion will go lickety split, if you've got $70 billion worth of short-term debt coming due in 12 months. I want to know how the moneys that we have there, with all the problems they have in their economy now, how that's going to stop the situation. How you're going to stop that. How you're going to prop up their economy. It just doesn't work.

Mr. Todd, continue, please.

Mr. TODD. By the way, I would note that out of that $29 billion, $30 billion total that I know about, probably about $5 billion would be required for debt service during this year, somewhere between $5 billion and $10 billion.

But the point is, until now, one of the disturbing things about this process was that an agreement would be coalescing around a given target number of how much assistance would be required. No sooner would the ink be dry on that agreement than here comes a whole new class of creditors looking for their share, as you so accurately put it.

How much warning was there during the last year that something was up, at least that could have been available in the Mexican press or for people who followed the Mexican central bank accounts? I believe the Banco de Mexico was publishing numbers throughout the year, showing the monthly shift in Tesobonos outstanding.

At the beginning of the year, there were only about $1.5 billion of Tesobonos outstanding. Most people wanted the higher interest rates that were available through the cetes instead. By December, there were $17 billion of Tesobonos outstanding. Somebody saw the train wreck coming and shifted out of cetes into Tesobonos in a big way.

That might be an amusing line of inquiry of the U.S. officials. As you saw this happening, what explanation were the Mexicans giving you for a shift of that magnitude? How much money has been drawn so far? You should probably ask them that and hopefully they'll tell you. I can infer that the Fed and Treasury ESF swap lines were increased to about $6 billion each at the time the President made his new commitment on January 31. We'll find out in a few more weeks officially. They'll tell you tomorrow or when the FOMC minutes of the February 1 meeting are released.

I believe that $7.8 billion of the IMF's money has already been transferred into the exclusive control of the Banco de Mexico. That occurred in early February. In addition, I believe that the whole $6 billion of the Fed and Treasury ESF swap lines has been drawn. That's $12 billion of U.S. moneys plus $7.8 billion from the IMF, about $20 billion that has been drawn.

I think the numbers that have been discussed with you this week—there's a $20 billion Treasury commitment and $3 billion that's been drawn. I think that's a $20 billion commitment on top of the swap lines.

You might ask those officials to clarify that tomorrow.

The point is that about $20 billion may have already moved and there's $20 billion roughly yet to go.

That seems to be the limit.

Something else that is very confused in the press accounts of what the arrangements are is what is the size of the total package the President has agreed to. Is it $47.8 billion or $50 billion thereabouts, or is it a smaller amount?

It turns out there was a very good article in the Financial Times of London a few weeks ago, that explained carefully both the IMF and the Bank for International Settlements' position on the matter.

The BIS made it clear that the $10 billion it agreed to is just a bridge loan to the IMF facility so that as the IMF disburses the additional $10 billion it has committed to, the BIS moneys must be paid down so that at the end of the day, you're not going to have $10 billion of the IMF plus $10 billion of the BIS; the one will offset the other.

That must be clarified; the true size of the total package, in other words, is about $37.8 billion. You can measure that against the Mexican financing need.

What would I do if I were about to draw up a statute in this case?

I would abolish the ESF, and I second Mr. Meltzer's recommendation on that point. The ESF was an idea that was comprehensible, even in 1934, only in the extraordinary circumstances of that time.

It was adopted at the end of the first New Deal Congress, when it would be fair to say, whether one is a Republican or a Democrat, FDR was at the peak of his near dictatorial powers and he, by God, wanted to tell the exchange markets what they ought to do. He wasn't going to listen to them. He'd just spent 6 months pegging the price of gold every day at random, after all, and he thought he could apply the same experience to the foreign exchange value of the dollar.

Even if the original ESF was constitutional, which is a questionable idea, I don't think it's been constitutional in the way it's been used ever since. If it had a constitutional day of existence, it was probably a single day in 1934 and not since then.

Why do I say that?

Because it crosses clear lines in the Constitution regarding the separation of powers.

We had noted earlier that the regulation of the value of money is a Legislative Branch function and even if Congress, in a fit of absentmindedness, transferred the power to do that to the President, it still might be the duty of the Supreme Court to say that Congress had not the power to do that, that there has to be accountability. If you were trying to salvage the constitutionality of the ESF, you would put their foreign exchange operations on an annual appropriations basis and require them to make full disclosure to Congress, holding nothing back.

The same applies to the Federal Reserve swap lines. It's my personal opinion that the Federal Reserve should not engage in foreign currency transactions, that the swap lines also should be terminated. There is no explicit statutory basis for the Fed swap lines or for the Fed's foreign exchange market interventions.

If it is desired to allow the Fed to continue in the foreign exchange intervention business, you want to put them on an annual appropriation for the foreign exchange operation, even if you leave the rest of the Federal Reserve budget alone. You want to put at least that small part of the Fed's budget within the appropriations process.

It's probably a mistake, in the long run, to allow funds like the ESF or the Fed's swap lines to operate on their own in this town without that much in the way of public, proper political accountability.

This is a view from outside the beltway so it sounds strange here within the beltway, no doubt, but this is a view widely shared west of the Appalachian Mountains, unpopular though it might be up and down the East Coast.

I would note that I believe I'm the only person who testified here today who lives outside of Washington.

Mr. FRANKEL. I live in California.

Mr. TODD. We have one Californian.

But the point is there are, or ought to be, limits on what people do regarding the value of currency, gold operations, and the like, within the beltway without a proper degree of political accountability.

That will conclude my remarks.

The CHAIRMAN. Thank you, Mr. Todd.

Dr. Frankel, there are three panelists here who share a different perspective. I'm going to start with you first, and ask you to try to limit your remarks in terms of time.

What should Congress do at this point?

Should we do nothing?

Should we inquire about how these dollars have been spent, and what the planned course is?

What would you do?

Mr. FRANKEL. Mr. Chairman, I actually think, beyond the goals you have of keeping fully informed of what's going on, which of course is the right of the Senate, that you should do nothing.

The CHAIRMAN. But should we keep fully informed?

Mr. FRANKEL. Of course.

The CHAIRMAN. That's a big concession from you. That's important.

Mr. FRANKEL. Fully informed doesn't mean——

The CHAIRMAN. Yes, tell me about that. What does fully informed mean? This is interesting.

Mr. FRANKEL. For example, I think there are some limits to how quickly officials can convey information to you on meetings after they've happened. I think there's some limits on the desire of U.S. authorities to maintain confidentiality of communications with the IMF and with other governments in the future.

The CHAIRMAN. Sure, but in terms of the amounts of moneys being drawn down and the conditions and terms and their utilization, you certainly believe—wouldn't you say that's a duty?

Mr. FRANKEL. Yes.

The CHAIRMAN. In your reading of the statute, wouldn't that be implicit? They're not just supposed to send over a report to us and we file it away. Wouldn't it be implicit that there's a duty for us to look at this, scrutinize it, and then make an evaluation as it relates to the information that we're given?

Mr. FRANKEL. I'm not a lawyer like Mr. Todd. I do not know exactly.

The CHAIRMAN. I'm not asking you about the legal niceties. I'm talking now as it relates to there being a requirement that information be given, but I would assume that there's a duty of oversight by Congress?

Mr. FRANKEL. Yes.

The CHAIRMAN. Mr. Mueller, what should we do at this point? I'm not asking you to comment on specific or proposed legislation, but what do you believe is the proper role for Congress?

Let's not go back into who told us, who didn't tell us, what did we know, or what didn't we know. What do we do, given what we know now, what elements would you look to going forward from this point on?

Mr. MUELLER. I think Mr. Todd's statement that money is a legislative function is well-taken. That's what the Constitution says. Although the powers have been delegated, you certainly have every right to know what's going on.

I would add that the requirements of confidentiality are somewhat overblown as far as how closely the information must be held. One of the difficulties with Mexico last year was that they began delaying the reporting of what was going on in their own economy. The issue of transparency, as it's called, in finding out what's going on in a timely fashion has been legitimately raised by the Clinton Administration. But that transparency should not then be held secret from the public.

It would aid in rewarding virtue, and punishing vice, among the governments involved if the information were publicly available on a timely basis—not, of course, anything proprietary that would give an unfair advantage, but I think that a sunshine requirement could push a lot further than the Administration probably is willing to go at this point.

The other point is, I raised the question in my testimony about the effect all this has on the U.S. dollar. I understand that Under Secretary Summers denies there's any relationship between the weakness of the dollar and the peso bailout. I think it would be perfectly legitimate to find out the reasoning of the Administration on that, as to how it is that if our monetary authorities purchase foreign exchange it does not have an expansionary effect, because that's really the whole point that Mr. Todd was talking about—warehousing and currencies and so forth.

The CHAIRMAN. If you warehouse, and you happen to warehouse an exchange that is going down, and you're trading in one that has been going up, meaning the yen and the dollar—in relationship to our dollar, we have big trouble, don't we? Does that play into it?

Mr. MUELLER. Yes. I think it makes a big difference whether you are trying to stabilize the value of the dollar or stabilize the value of the peso.

In the one case, you are hardening the dollar. In the other case, you are weakening the dollar. There's a big difference.

The CHAIRMAN. I'm trying to learn. They're taking yen and marks, which are being held in the ESF accounts, and effectively swapping them for pesos. And that is going to significantly weaken the dollar, given what's taken place, if they have been doing this in the past 10 days or so.

Mr. MUELLER. It's not clear to me that they are actually making a one-for-one switch between the yen and the Deutschemarks.

The CHAIRMAN. No. But in the final analysis, if that is what takes place, if they're replacing yen—and I don't know whether this happens—if they're replacing yen and marks with pesos, is that what they, in essence, would be doing by purchasing pesos?

Mr. MUELLER. They could be purchasing pesos on top of the assets they already have. But then you've got the problem that you have a declining currency. To defend it, you'd be forced to sell your yen and Deutschemarks.

What's happening in the market suggests that they were at first purchasing pesos, and only more recently selling yen and Deutschemarks. But they're not required, as I understand it, to limit the amount of peso purchases.

The CHAIRMAN. But as that peso is dropping in value, aren't we being hurt?

Mr. MUELLER. We are exchanging a high-quality asset for a low-quality asset. There's no question.

The CHAIRMAN. How long will it take the currency speculators to figure that out?

Mr. MUELLER. A matter of minutes.

The CHAIRMAN. Mr. Todd, do you have any idea, given your peculiar expertise?

Mr. TODD. The warehouse is the way out of this mess for the Treasury in the near term. In fact, because of the way the ESF's funding and accounts are set up, as Mr. Mueller is describing, issuing Treasury bills for the purpose of purchasing pesos won't happen. Instead, the spare dollars are used up that are already in the ESF so that they get down to only their final holdings of Deutschemarks and yen—about $20 billion. I've been assuming that's why the magic number of $20 billion was picked as to how much money we would commit to Mexico, because that was about the limit of the free assets that could be used somehow.

The Deutschemarks and yen would be taken to the Fed and pledged to the Fed in the arrangement that the Fed calls the warehouse. This is also an extra-statutory arrangement, by the way. So the Deutschemarks and yen are pledged into the warehouse, and the Fed provides dollars back to the Treasury. That's what the Treasury uses to buy the pesos.

Over time, you will find the Fed holding for the Treasury Deutschemarks and yen, with the Treasury holding $20 billion worth of pesos, if it comes to that. But at the end of the day, even if the Treasury suffered a loss on the peso account that it held, the Fed would show a bookkeeping profit on the Deutschemarks and yen that it held for the Treasury, and would transfer that profit to the Treasury, one for one. So the Treasury, at the end of the year, might be able to say, "Well, it was a wash. No profit, no loss."

Mr. MUELLER. I'd like to make it clear I was referring to the economic effect, and not the legal fiction of what's going on. It's the same as if the Treasury had issued Treasury bills which were then monetized, but the economic effect is the same.

Mr. FRANKEL. I'd like to say something on this.

It is easy to get confused by this issue. I think it is important to make it clear that the Federal Reserve can set U.S. monetary policy to whatever it wants, regardless of any of these transactions. And it will do that. I don't think we should lose sight of that. There's no necessary connection between any of these transactions and Fed monetary policy.

The CHAIRMAN. Mr. Nader, I'd be interested in your perspective. As a Senator or Congressman, what do you think the appropriate, measured action should be? I said "measured."

Mr. NADER. First of all, the reason why so many bad mistakes were made by this Administration, and the reason why these policies are not working out, is because they are developed outside the rule of law. They are developed outside the structure of public information and accountability to Congress and to the public, and justified as such.

I found Fred Bergsten's proposal, that the secrecy should parallel that of the intelligence agencies with their counterpart Committees in Congress, rather deplorable. When government operates in the dark, you get secret government. When you get secret government, you're more likely to make bad mistakes. When you make bad mistakes, you're likely to want to cover them up. And when they can no longer be covered up, you are likely to postulate horrible domino effects throughout the global economy in order to extort more money from Congress and the taxpayers in order to cover your mistakes.

How do you get out of this increasing morass which the Administration is getting into?

First, you have to establish a framework for congressional policymaking. That means you've got to bring the Freedom of Information Act to bear on these dark recesses of the money managers in Treasury and the Federal Reserve. The banks should not be exempted from the Freedom of Information Act. The Treasury and the Federal Reserve should be more open.

The second thing that needs to be done is to take control of the money function, as Mr. Todd said. It's clear about separation of powers: The appropriating function, the money function, is in Congress. And that has to be done by new legislation. It's got to be done because—let's face it—there's a huge vacuum, especially over the last 7 years, of any kind of statutory accountability for these trade situations.

Third, you need to start getting the Administration to stop saying to you, "We cannot say what's going to happen or what we're going to do, because this would signal to the money markets, et cetera."

One thing you can ask them is, when are they going to come back to you and ask you to replenish the tens of billions of dollars that have to go back into the Exchange Stabilization Fund and the IMF? They can't get away from that. The other countries who are members of the IMF have basically given the United States a pass. "OK. You want all this money to go to Mexico? We know who's going to end up paying for it, don't we? It's going to be Uncle Sam." So, have them give you some sort of timetable and quantitative estimate here.

Now, Mr. Seidman had a very interesting proposal when he testified in the House. They asked him, "What would you do?" This was in January. "Having had some experience with bailouts," he mentioned in a wry fashion, "if the pro-bailouts are right about there being no real economic problem in Mexico in the long term, that the fundamentals of the Mexican economy are sound, there should be no panic."

He said, "Talk of panic will produce panic." He went on to say:

The problem we're facing in Mexico, in the immediate phase, is there is too much short-term borrowing by Mexico that lead to losses. And the debtors and creditors should sit down and negotiate a settlement, with the U.S. Government as the referee.

Look at what we did in the early 1980's when Mexican loans and debts, et cetera, were a problem. We didn't do what we did now. In other words, we're getting more reckless in terms of bailouts.

Mr. Seidman's words were:

Congress is right to hesitate. Although reversing course at this point will be difficult, and the screams of disaster will be deafening, the course being set in haste can only lead to larger U.S. financial obligations, and the reduction of market discipline. That's just the way we don't want to go.

At the bottom of the Administration's problems, Senator, is that they made a decision that everything they do vis-a-vis Mexico is to shore up the present regime. Two years ago, almost to the day, I was sitting with Mickey Kantor with my associates, and I was pressing him on that. He finally blurted out, "We must assure that Salinas' successor is elected."

The CHAIRMAN. We bought into the theory, didn't we? I believed that theory. I think most people were sold on the theory that this was a whole transformation, given the educational backgrounds and quality of the top ministers, economic, legal—the whole. I certainly was one who—you look at this, and you hope for a transformation, et cetera. I think I was just blinded, or many were blinded, by that which appeared to be gold—a wonderful movement into the era of democracy and real competition, and a government that was willing to encourage competitive forces and stop attempting to restrain. That was a very popular theory.

Mr. NADER. Exactly. Mr. Kantor told that to a lot of people. But imagine that the U.S. Government was committing itself to a political alliance with an incumbent regime that had rather dictatorial precedents, whatever its so-called verbal promises were. And that is what is at the basis of all this commitment, constantly: To put more good money after bad.

Let the emerging democratic activities in Mexico work their will, and realize that this regime has finished its tenure with the Mexican people, that there's going to be different political parties, which are already emerging, and that there's going to be different policies, but not as long as this regime thinks it's got an all-purpose guarantor called Uncle Sam in Washington, DC.

The CHAIRMAN. In fairness to the Clinton Administration—I know there are going to be some people who think that's rather ironic coming from me—we have to say that this was rooted in policies that go back a number of years with our Government, talking about, vis-a-vis, the relationship with the Mexican government. I think you have to understand the broader situation, et cetera. So this is a tradition that has been continued and enhanced. I think we were blinded from the realities.

Mr. NADER. But much more pronounced. We simply can't have our relations with Mexico defined as bailing out U.S. investors in Mexico, as being intimidated by Mexico if it says it's going to unleash more illegal immigration to the United States, or it won't cooperate with the United States regarding the drug trafficking—

which is increasing now, in part because, under NAFTA, there's a reduction in the frequency of inspections of more trucks coming into the United States.

Where does all this end, if we don't have a steadfast, bold public position by Congress to write a new chapter in these relations, one that will help the real plight of the Mexican people, not just our own fiscal and political standards?

The CHAIRMAN. Mr. Mueller.

Mr. MUELLER. Mr. Chairman, just one last point about the increase to ask the Administration. The whole point of this plan, as I understand it, is supposed to be to help stabilize the peso, as well as to allow Mexico to meet its obligations.

The question to ask is how, if the Administration believed at the time of the crisis that the peso was 20 percent overvalued, how do they explain why it's now almost eight to the dollar? Their argument is that things would be much worse if it weren't for the plan.

How is it, exactly, that a currency that's 20 percent overvalued falls a certain amount, but then goes to eight to the dollar after the plan begins? You might want to focus on the function. I mentioned the expansionary impact on our economy. The papers I submitted concerned the expansionary impact on Mexico's economy—that is, $50 billion, or $40 billion to take Mr. Todd's figure, is about four to five times the total money supply, the narrow currency and bank reserves, of Mexico. It's nearly twice as large as the current account deficit we're trying to get rid of.

The question is, how can you inject that much new credit and debt into an economy and not have consequences? In effect, it prevents rather than promotes the adjustment to a self-sustaining Mexican economy. And I think there is where you might want to look for why things seem to be worse after the package than before. It's expansionary.

Mr. NADER. The bottom line, Senator, is that you can't move toward an economic union with a dictatorial regime, with unbelievable concentrations of wealth and corruption in a few hands. Senator Moynihan once said, "You can't have free trade with a country that's not free." That was a rather simplified statement, but the levels of development between the United States and Mexico are so wide, as are the different levels of rules of law and democratic procedure and distribution of wealth, that, inescapably, if we get entangled with countries such as Mexico so intimately, we are going to be obligated more and more to shore up their sinking ships and the regime that happens to control that country at that time. That means we will be experiencing a pull-down in our standard of living rather than the reverse pull-up.

I think you should prepare a request for the Administration to deliver to the Committee what can be called the Mexican peso documents, and start listing the kinds of materials that you know exist or must exist in the Executive Branch that have not been made public, and put them together in a public Committee collection. I do not like the idea that is spreading among the Executive Branch, where they hold press conferences, give the press a 10-page summary, and then say, "Well, the real document comes later."

They did this with NAFTA under President Bush. They didn't even give the press the real document until a month later, and then we, the citizens, couldn't get it from the GPO until 4 months after that.

The same thing happened with the precondition document, which is about this thick, on the Mexican bailout. It was not available immediately to the press. They had a 10-page press release.

This is not totally accidental. This is not a breakdown in the copying machines.

The CHAIRMAN. I will just share with you—and I don't mean to hold any of you longer—a letter I received from Mr. Rubin, which was made public. It was really an attempt to say that you, as a Senator—and I've attempted to act in a very responsible manner—you may be the cause and the reason for the currency declines, et cetera, and for the problems, in exacerbating the problems.

I have to tell you, if raising inquiries would be met by a democratic Government by saying these things—a Member of Congress, any Member of Congress, or a citizen that is asking how money is being spent, "Please tell us about this"—I think it is incredible. I think it is nothing more than an attempt to justify what they've done, and tell us to be nice and go over there and keep quiet.

I also would think that by taking the good-faith effort of the Speaker and of the Senate Majority Leader—and I think they were good-faith efforts—in their belief that the Administration had a sound program, and in their saying we are going to be supportive, that they are now using this as a club to somehow say:

> Look. Everything that we're doing has been promoted, has been signed off on, has been sanctioned by the leadership of the Congress. Therefore, keep quiet.

It is rather apparent to me that some of my colleagues have attempted to use that argument as a vehicle to silence me.

Mr. NADER. This is a technique used by Executive Branches in past years. Secretary Bentsen, when he was a Senator, exploded in anger in 1988 at a Senate hearing with an Administration official. And he said:

> I'm sick and tired every time I ask you a question, you say we can't talk about this, because it will destabilize the bond market, it'll destabilize the stock market.

That should be a code word for intimidation any time the Executive Branch tries to silence Members of Congress with that pretext.

The CHAIRMAN. I believe that the media's getting this letter at the same time it was sent to me is an attempt to silence me. I think it's interesting, frankly, that the media gets the letter at the same time that I get it.

We have responded today with our own letter to the Secretary reaffirming our request, and the legal authority by which we do so, to ask for information that, under the wildest stretch of imagination, should not be withheld. We're not asking for personal correspondence. We're asking for policy. We're asking for documents upon which decisions were made that involve tens of billions of dollars of taxpayers' money.

If you want to say that the taxpayers aren't entitled and Congress shouldn't know, that will be the issue we will join. And I can assure those who attempt to keep me from pursuing this matter that I will not be deterred. I will go forward, and I would hope that

I would do it regardless of what Administration was proposing this action.

By the way, it may develop that they can put forth a great and wonderful and comprehensive program for dealing with the problems that are there. I doubt it, but they may. If that is the case, I would be pleased.

But I think we certainly have a right to know, and I think that's what it comes down to. Sometimes, I'm wondering if I'm in a different world. Look around, and you find yourself at the end of the tirades and bombardments to what I thought were rather reasonable requests for information.

Do any of you have any further comments before we close? Because I certainly think you're entitled to them.

[No response.]

I want to thank each and every one of you for coming and staying until 3 p.m. This hearing started at 10 a.m. For being as patient as you have been, you have the thanks of the Chairman.

We stand in recess.

[Whereupon, at 3 p.m. on Thursday, March 9, 1995, the Committee recessed, to reconvene on Friday, March 10, 1995, at 10 a.m.]

[Prepared statements and additional material supplied for the record follow:]

PREPARED STATEMENT OF JOHN J. LaFALCE

U.S. REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

MARCH 9, 1995

Mr. Chairman, I appreciate your invitation to testify before you on an issue to which I have devoted substantial time and thought, particularly during the NAFTA debate when, as Chairman of the Small Business Committee, I held more than a dozen hearings related to Mexico. I also wish to thank you for your own leadership on this issue.

It is important that we review what happened and why with respect to Mexico's currency and economic situation, and the U.S. response to it, but our purpose should not be to cast blame. Rather, we should look to the future and apply the lessons we have learned.

In my testimony this morning, I want to make the following major points which embody some of the lessons I believe we should take away from this experience. *First, the United States should never again enter into free trade agreements without appropriate currency provisions. Second, we must give as much attention to the rights of labor as to the rights of capital in negotiating international trade agreements. Third, U.S. intervention policy in situations like Mexico must be guided by predetermined criteria and standards that preclude* ad hoc *decisionmaking based on political and other circumstances. And, fourth, we must reassess the conditions of our participation in NAFTA, reevaluate our assumptions about the underlying soundness of the Mexican economy, and reconsider the North American currency situation.*

I. The United States should never again enter into free trade agreements without the protection afforded by appropriate currency provisions as an integral part of the agreement.

A. *Changes in currency relationships have a dramatic impact on trade relations that cannot be ignored in formulating trade agreements.*

There has been substantial volatility in international currency markets in the last decade. For example, in 1985 the U.S. dollar traded as high as Y263. This week it has hit an all-time low, trading just under Y90 to U.S. $1. In 1988, when the U.S.–Canada Free Trade Agreement was signed, the Canadian dollar equaled about U.S. $.90. Now the Canadian dollar is trading around U.S. $.70. In November 1993, when the U.S. Congress approved NAFTA, the peso equaled about P3.5 to U.S. $1. This week the peso fell to a new low of P7 to U.S. $1. European currencies also have experienced substantial volatility. In fall 1992, three currencies temporarily withdrew from the European Monetary System and speculative pressures have continued on the pound, lira, peseta, escudo, French franc, Danish kroner—all objects of heavy speculation. This week European Union currencies are again being buffeted.

Such volatility has a profound impact on international trade. For example, let's take our largest trading partner—Canada. If one compares movements between the U.S.–Canada trade balance and the exchange rate fluctuations between the U.S. and Canadian dollars, one finds nearly perfect symmetry. In the case of Mexico, devaluation has brought an immediate change in the U.S.–Mexico trade balance. The United States had a strong and growing trade surplus with Mexico as the peso was kept at the approximate 3.5:1 exchange. Following devaluation in December, Mexico posted a trade deficit with the United States in January. The primary reason is that the dollar can now buy twice as many products from Mexico. In turn, with a nearly 50 percent devaluation since December, Mexican workers can buy only half the U.S. products with the same amount of pesos.

If we are to avoid future problems like the one we face today, we cannot enter into free trade agreements without currency exchange provisions. Moreover, an existing free trade agreement cannot remain fixed in stone in the face of substantial changes which call into question some of the fundamental premises behind the agreement. As you recall, supporters of NAFTA widely advertised the U.S. export gains and job creation that would result from NAFTA. The core assumption, always implicit rather than explicit, of the econometric models projecting such gains was that the peso-dollar relationship would remain stable at about P3.5.

The fundamental premises behind the NAFTA agreement are no longer operative, and the gains proponents cited will now prove illusory. We must consider immediately whether some corrective mechanism which can adapt NAFTA to the new conditions we face is in order. I call upon the USTR and the Treasury to meet with Canadian and Mexican trade and finance ministers to consider this issue.

During debate on the U.S.–Canada Free Trade Agreement, I argued strongly that currency provisions ought to be made part of the agreement. I also urged the Administration to negotiate a currency side agreement in NAFTA in the belief that we could not have a good NAFTA without currency provisions. In May 1993, I held a hearing in which prominent American and Mexican economists warned of a probable peso devaluation after NAFTA came into effect. I then wrote to the President, the Secretaries of the Treasury, Commerce, and Labor, and the USTR among others, conveying my belief that such currency provisions in NAFTA would be essential. Responses from the Secretaries of the Treasury, Commerce, and Labor assured me that a currency mechanism would not be necessary. Specifically, Treasury wrote that "Treasury monitors developments in exchange rates closely," and further, "Treasury Department officials consult regularly with our Mexican and Canadian counterparts on macroeconomic issues, including fiscal and monetary policy and, as appropriate, exchange rate policy." The confidence placed in existing mechanisms was obviously ill-placed.

B. *There is a real question as to whether we can have totally free-floating currencies in today's interdependent global economy—made more interdependent by communications technology that allows instantaneous currency transactions. U.S. policy must focus more closely on the problems posed by the current exchange rate system and the effects on trade agreements.*

A single currency is a fundamental premise of every true economic union. The fundamental premise of our Constitution was to create a political *and economic union*. The interstate commerce clause has been integral to the success of that effort, and could never have proved effective without a single currency. While the European Union has experienced substantial difficulty, it is nonetheless working toward a single currency as the *sine qua non* of its effort to achieve true economic union. The absence of such a currency has posed serious problems.

Fundamental changes in currency relationships can, and often do, undermine trade agreements. In some circumstances, exchange rates can act as actual trade barriers at the same time that we try to otherwise eliminate trade barriers through negotiations. This issue has become more important to the United States as we have seen trade as our percentage of GNP rise from about 8 percent in the 1970's to nearly 30 percent today . . . and it will continue to grow much greater.

Clearly, the free-floating exchange rate system needs reexamination. National authorities cannot now guarantee the effectiveness of their monetary policies. We are too interdependent. Monetary intervention usually has little lasting impact, if any. Currency traders can instantaneously affect countries' trade, interest rates, and economic plans.

There are those who call for a return to the gold standard. My thinking has evolved on this, and I now neither support nor reject the idea. There are many other alternatives. But I do know we must reassess the current system, for it no longer serves us well.

I believe we must broadly reexamine how we deal with international currency markets and how we protect the value of currencies in a way that allows reasonable economic decisionmaking and permits economic fundamentals—not speculative trading—to drive the operation of economics and markets. The international currency turmoil we have experienced benefits no one but the speculators and traders.

Further, I firmly believe that our economic tie to Mexico is putting serious downward pressure on the dollar. We are about to enter a quagmire. Proponents of the support package argued that, first, our economic partnership in NAFTA required us to intervene, and second, intervention was necessary to calm currency markets. I believe the converse is true. Our intervention has created the international perception that there is an economic integration between the United States and Mexico. Hence, rather than our pulling Mexico up, I fear they are pulling us down.

Additionally, technology and international financial services change rapidly. New techniques for making profits evolve continually—often ahead of the regulatory regimes which oversee them. We must make sure that regulatory regimes keep pace with new market developments, such as the recent phenomenon of U.S. pension fund investments in Mexico, and maintain proper oversight.

II. We must give as great attention to the rights of labor as to the rights of capital in negotiating free trade agreements.

A. *Global capitalists rather than ordinary workers often drive the terms of free trade agreements and reap the primary benefits.*

We confront a new phenomenon in global markets—global capitalists in the form of transnational corporations. These companies are often the members of the business community most concerned about the terms of free trade agreements and most well-positioned to influence them. Their input is reflected in the nature of the agreements, which routinely reflect an almost exclusive concern with the "rights of capital"—e.g., an emphasis on protecting intellectual property, telecommunications, and specific export products. Little or no attention is given to the rights of workers who make the products.

B. *While transnational corporations virtually never lose from the terms of free trade agreements or the vagaries associated with currency fluctuations, average citizens on both sides of the relevant borders do.*

Transnational investors have the discretion to move their resources and operations around the globe to maximize benefit, e.g., choosing countries to serve as springboards for exports. Global capitalists make "discretionary investments"—if they lose in one area, they can gain in another. Workers do not have that luxury. For workers affected by currency devaluations, wages are not discretionary. The peso devaluation has struck at the heart of the standard of living of the Mexican worker, and effectively eliminated the export opportunities NAFTA was to create for U.S. companies. Moreover, U.S. companies and citizens can now buy twice the Mexican goods, placing the jobs of American workers at risk.

C. *The protection and promotion of workers' rights must be a major consideration in the negotiation and formulation of all future free trade agreements. Either we bring them up, or they pull us down.*

In my view, we can no longer ignore the rights of workers as part of the free trade equation. Our world is shrinking, transnational corporations have the ability to move capital and production around the globe, and workers' rights in one country increasingly affect the rights of labor in other countries. We must confront this fact and consider ways to ensure that the rights of capital do not smother the rights of workers. We will either bring workers' standards of living up as part of these agreements or our indifference to their concerns will ultimately bring these agreements down.

III. U.S. intervention policy in situations like Mexico must be guided by pre-determined criteria and standards that preclude ad hoc decisionmaking, minimize risk to the U.S. taxpayer, and are subject to on-going monitoring and review.

I opposed the $40 billion loan guarantee package first proposed by the Administration. Further, I would have counseled against use of the ESF for a $20 billion support package. Review of the legislative history and statutory language strongly suggests that Congress did not intend or contemplate that the ESF be used in this fashion. However, while it was not congressionally intended, because of the statutory language, I do believe it is legally permissible. Prospective legislation to clarify future use of the Fund may be called for.

A. *The important question is whether or not we are implementing sound policy. I am concerned that we have not thought through a framework for such policy decisions and determined what standards should govern such interventions. We must ensure that we will not throw good money after bad.*

The Administration's goals and objectives, and its standards for judging success, are not as clear as they should be. If we are intervening in Mexico with the purpose of restoring confidence in Mexico, that is foolhardy. We cannot restore confidence in Mexico. We can only substitute confidence in the United States for confidence in Mexico with a multi-billion-dollar package. Only Mexico can restore confidence in Mexico.

If we are intervening to allow Mexico to meet its debt obligations and restructure its debt, I would still object. Our stated objective of the support package has been to allow Mexico to roll over and stretch out its short-term debts, to bring investors back into the Mexican market. But we must also be concerned about developing the conditions that will induce investors to stay for the long term. Policymakers have not addressed the issue of hot money—if it leaves once, it can do so again.

If, on the other hand, we are intervening for the purpose of stabilizing and strengthening the peso, then I would have an open mind on the issue, for it is imperative that Mexico prevent further drift of the peso and that it be revalued significantly.

Both the Administration and Mexico must be clearer about their intentions. Furthermore, Treasury needs to ask itself precisely how much it will spend, at

what pace, and to what end. Rescue efforts that go against market trends which reflect fundamentals are doomed to fail.

Proponents of the support package frequently make the argument that however bad things are now, it would have been worse had we not intervened. One can always make that argument, but in this case I believe it is the utmost sophistry. We may well be creating a much larger problem than the problem we are attempting to solve; we should seriously consider whether and how we can cut our losses. If we do not, $20 billion could simply be the entrance fee to a bottomless pit.

B. *We may be intervening in Mexico based on incorrect assumptions about Mexico's economic soundness, and we need to reexamine those assumptions.*

The basic premise of the support package has been that Mexico is suffering a short-term liquidity crisis but that the underlying fundamentals of the Mexican economy are sound. There is substantial evidence to the contrary.

Real wages are stagnant, small- and medium-sized businesses are closing, 250,000 employees have lost their jobs since December, auto companies have announced temporary plant closings, and the domestic banking system is crumbling under the weight of high interest rates and debt defaults by consumers. This week, Mexican bank regulators warned that as many as 10 of Mexico's 16 domestic banks would require capital infusions from the government in order to continue operations.

Two pillars of Mexico's economic reform package and the U.S. support package are the profitability of Pemex, Mexico's national oil company, and Mexico's privatization policy. If Mexico defaults on debt owed to the United States, our loans are theoretically secured by Pemex. Recent reports do not strongly endorse Pemex's financial soundness. Moreover, this is not effective collateral. We would not use it because exercising this option would only make the situation worse.

The direction of Mexico's privatization policy is of even greater concern. Because of the poor financial condition of the companies and utilities, further privatization faces serious difficulties. Perhaps more importantly, privatization is not spurring economic growth but is stirring economic resentment. *Too often in Mexico, "patron privatization" has been the procedure of choice. Rather than helping to distribute the wealth, privatization policy in Mexico has concentrated it further, as friends and relatives of those in power took favored opportunities to acquire assets. Privatization is an opportunity to ensure that the net is cast widely allowing large segments of Mexican society to participate in the process—that opportunity is being ignored. There is no U.S. policy that would help shape an equitable distribution. Moreover, this is a global problem, not just a Mexico problem.*

C. *Congress should provide close oversight, but it should not micro-manage by legislation in the current crisis.*

Once the President acts and sets a policy in motion, certain expectations are raised that affect markets. We do not know what effects a policy reversal or congressional intervention might have.

I do believe, however, that Congress has an essential oversight role which should force the Administration to more clearly identify and think through critical goals and mechanisms for achieving them.

We must also develop a framework and criteria for determining the appropriate levels for successful intervention. To date, Treasury still has not satisfactorily answered the question of how the $40 billion or $20 billion amount for the support package was determined.

Mr. Chairman, in 1988, the Omnibus Trade and Competitiveness Act included a provision requiring a report from the Treasury Department on international economic policy and exchange rate issues every 6 months. The last one was issued in December—a copy of which I have here—and the next one is due out in April. This report could provide an important tool in this oversight function. I urge your Committee to hold hearings on these reports and to focus on these issues on an on-going basis.

Having said that, I am distressed at the glaring omissions in Treasury's last report. When I authored this provision, I intended it to provide a serious opportunity to anticipate and highlight exchange rate problems. Mexico devalued the peso in December. The Treasury reported in December. Yet, despite our entry into NAFTA, the Treasury did not deem the enormous impact such a devaluation would have on the agreement worth mentioning. Nor is any attention given to Canada's currency difficulties, despite the fact that Canada is our largest trading partner. I am at a loss to explain how a report on international ex-

change rates—mandated by Congress—would fail to have even one word on Mexico or Canada.

D. *Finally, Mr. Chairman, I want to raise the issue of our largest trading partner, Canada. Now, not later, is the time to anticipate and develop policy options concerning what some have termed "the quiet crisis" north of our border with respect to the Canadian dollar.*

U.S. policymakers must consider our intervention policy anew—not only with respect to LDC's, and not just as part of a G–7 coordination approach. Rather, now that we are a partner of the North American Free Trade Agreement, I believe we should consider what exactly we could or should do, if anything, if Canada's currency confronts heavy downward pressure. Can we anticipate currency difficulties and act with confidence based on well-considered policy options developed in advance of their need? I would hope so.

Mr. Chairman, we have an opportunity to think broadly and creatively when we allow ourselves to anticipate and think ahead. In considering the role of the dollar, the potential for the peso further dragging down the dollar, and possible Canadian dollar difficulties, now may be the time to contemplate a single currency for NAFTA exchange transactions. Just as the European Currency Unit, or "ECU" has been used by the European Union, perhaps we should think about a similar mechanism for NAFTA partners.

Thank you, Mr. Chairman, for the opportunity to address this important issue before your Committee.

PREPARED STATEMENT OF FLOYD H. FLAKE

U.S. Representative in Congress from the State of New York

March 9, 1995

Mr. Chairman and Members of the Committee, thank you for allowing me the opportunity to testify before the Senate Committee on Banking, Housing, and Urban Affairs. The crisis in Mexico and its related effects upon the Exchange Stabilization Fund have caused considerable controversy, and it is appropriate that Congress address this issue. At the very least, we in Congress have the responsibility to learn the facts of the current crisis, and to take every opportunity to find prospective solutions.

Mr. Chairman, I do not testify here today as an expert in international finance. The presence of economists will serve you better in that role. However, like every other Member of Congress, I am concerned about the size of the Mexican bailout, especially in an atmosphere of overall budget cuts. More importantly, the American people are concerned. Therefore, I believe it is incumbent upon the Administration to assuage our collective worries.

Mr. Chairman, let me explain my understanding of the U.S.–Mexico deal. As you most certainly are aware, the United States and Mexico have signed agreements implementing a $20 billion support package from the Exchange Stabilization Fund. Ostensively, this package is intended to protect jobs, exports, immigration interests, and security concerns caused by Mexico's lack of liquidity.

In return, Mexico has committed itself to an economic program which it purports it will follow in order to restore financial stability. The U.S. effort, through the Exchange Stabilization Fund, is expected to bolster that effort, by allowing Mexico to meet short-term debt. Finally, the proposed safeguards include notification, evaluation procedures, and the use of crude oil to secure repayment.

Senators, I *am not* here today to specifically criticize the Clinton Administration's proposal. I, like many other Democrats and Republicans, concur with the President in his belief that the Mexican economic crisis is of grave concern to the U.S. economy. Instead, my general complaint is the apparent lack of diligence in convincing and educating Members of Congress and the American public about the specific components of the bailout.

Senator D'Amato and Members of the Committee, I would, however, voice my specific concerns about the concept of bailouts. Beyond the fact that the financial world no longer recognizes international frontiers, I am concerned about the Third World nation within our frontiers. I have come to realize why so many people have voiced complaints, and in spite of their sympathy for the Mexican dilemma, have stated quite correctly that there are many problems in America that need to be resolved. It is my hope that, as we have been able to come together today for the purpose

of addressing the peso problem, we might also do the same thing as we look at the many problems which are endemic to communities here in America.

Mr. Chairman, I think as we discuss loan guarantees for Mexico, and we look at avenues by which we might arrive at a resolution of our crises existing in our urban communities, what I have named America's Third World, there is a necessity for us to also have the same kind of aggressive vigilance as we solve problems here at home.

I think most Americans are more than willing to support any program that might assist our neighbors. However, like most Americans, I think good charity begins at home. Because of that simple credo, many of our citizens would be more comfortable in supporting the Mexican bailout if they were not losing jobs, if they did not see their communities deteriorating, if they did not see our children starving, if they did not see our educational system crumbling to a shamble, and if they did not see criminals running rampant in the streets.

Mr. Chairman, I will close by stating that the best uses of our resources begin here at home, which means providing a level of stability for every citizen, so that they understand that the responsibility of Government is to try to bring them the quality of life that is consistent with our talking about our being a democracy. More importantly, even as we export that democracy abroad to Mexico and other struggling nations, we ought to do everything within our power to make sure that it is the essence of a quintessential nation in which all citizens are included.

PREPARED STATEMENT OF L. WILLIAM SEIDMAN

CHAIRMAN OF THE BOARD, COMMERCIAL MORTGAGE ASSET CORPORATION;
FORMER CHAIRMAN OF THE FDIC, WASHINGTON, DC

MARCH 9, 1995

Mr. Chairman and Members of the Committee, thank you for the invitation to these important hearings.

When I last appeared before you on January 31, it was with the message that the proposed Mexican bailout was bad for the Mexicans, bad for the United States, and bad for the world markets. Nothing that has transpired since then changes my view, and much that has happened would appear to support it.

My purpose today is not to violate my mothers often repeated statement to me, "Never say, 'I told you so,'" but rather to discuss what we have learned from recent experiences with the new world of high velocity markets powered by the computers, hedge funds, trillion-dollar-a-day trading, government interventions, and world-wide participation.

In the last few days, *the world's financial community has fired a shot across the bow of the U.S. financial ship of state*. The recent behavior of the dollar indicates to all who observe that, "You, too, Uncle Sam, are subject to world markets."

In my view, it also warns that no country, even the United States, is in a position to be banker of last resort to world markets. The old idea of stabilization funds simply is not effective in the financial world which we have created. The U.S. Federal Reserve Board, the U.S. Treasury, the IMF, and the BIS are pebbles on the beach when the financial tides roll in.

There has been considerable discussion of whether the use of the Exchange Stabilization Funds *entire* net position of less than $20 billion to support Mexico was appropriate (Exhibit I). Does it reduce the ability of the United States to support the dollar when it is in trouble, as it has been recently? The answer from the Government officials has been, we have plenty of resources, even with this action. While it seems somewhat strange that committing the entire Stabilization Funds net position has no effect on stabilization funding availability, I believe the real point is that the use of this or other funds to act as banker of last resort or to stabilize currency doesn't work, except, perhaps, temporarily.

The United States needs a stable, fully-valued dollar and that can come only from sound economic policies. It seems beyond question that two U.S. economic decisions, the Mexican bailout plus the defeat of the Balanced Budget Amendment, helped send the dollar on its recent slide when they were piled on our long record of low savings and large foreign borrowing.

From this experience, three things can be taken note of for future action.

One, the world market system now polices the world markets. The shot over our bow is proof again that markets show no discrimination. Like every market system, world financial competition can be brutal in governing its markets. To mitigate this harshness, the best weapon is information freely available to market players, some-

thing that clearly was not the situation in the Mexican situation. The world needs to work on a system that will close the markets to those who do not clearly disclose.

Two, reliance on central bank or Exchange Stabilization Fund interventions is not an effective tool for any sustained period. Thus, it is certainly appropriate for Congress to review the use of, and need for, a large Exchange Stabilization Fund. Is it appropriate to use such a fund for long-term lending and is the amount appropriate, given the obligations which it recently has undertaken? Would the United States be better off to take the Fund and use its balance to reduce the U.S. budget deficit and let the Fed deal with temporary stabilization problems with its current resources? Why should such a large sum be available to the Executive Branch without congressional control?

Three, long-term interest rates in the United States will be determined, to a large extent, by investors world-wide, since they are our marginal lenders. What will foreign investors demand to finance our bad habits, budget deficits, and lack of savings? We have fundamental economic problems that we need to address. As has been said many times, there will be no one available to bail us out if we fail to heed this last warning shot!!!

Public enterprise funds:

EXCHANGE STABILIZATION FUND

Program and Financing (in thousands of dollars)

Identification code 20-4444-0-3-155		1994 actual	1995 est.	1996 est.
	Program by activities:			
10.00	Total obligations (object class 92.0)	239,979	1,300,000	1,320,000
	Financing:			
	Unobligated balance available, start of year:			
	Fund balance:			
21.90	Special drawing rights	-9,292,914	-9,371,503	-10,406,350
21.90	Treasury balance	-16,341,884	-16,091,093	-16,650,175
21.91	U.S. Securities: Par value	-5,636,630	-7,325,769	-7,631,330
	Unobligated balance available, end of year:			
	Fund balance:			
24.90	Special drawing rights	9,371,503	10,406,360	10,802,360
24.90	Treasury balance	16,091,393	16,650,175	17,283,775
24.91	U.S. Securities: Par value	7,325,769	7,631,330	7,921,730
25.00	Unobligated balance expiring	-239,979		
68.00	Budget authority (gross): Spending authority from offsetting collections	1,566,377	2,600,000	2,640,000
	Relation of obligations to outlays:			
71.00	Total obligations	239,979	1,300,000	1,320,000
87.00	Outlays (gross)	239,979	1,300,300	1,320,000
	Adjustments to gross budget authority and outlays:			
	Offsetting collections from:			
88.00	Federal sources		-1,300,000	-1,320,000
88.20	Interest on U.S. securities	-704,893	-168,600	-171,600
	Non-Federal sources:			
88.40	Special drawing rights holdings	-32,906	-364,800	-369,600
88.40	Net gain on exchange transactions	-928,578	-767,800	-778,800
88.90	Total offsetting collections	-1,566,377	-2,600,000	-2,640,000
89.00	Budget authority (net)			
90.00	Outlays (net)	-1,326,398	-1,300,000	-1,320,000

The Secretary of the Treasury is authorized to deal in gold and foreign exchange and other instruments of credit and securities as deemed necessary, consistent with U.S. obligations in the International Monetary Fund (IMF), regarding orderly exchange arrangements. An Exchange Stabilization Fund, with a capital of $200 million, is authorized by law for this purpose (31 U.S.C. 5302). All earnings and interest accruing to this fund are available for the purposes thereof. Transactions in special drawing rights (SDR's) and U.S. holdings of SDR's are administered by the fund. U.S. drawings from the IMF are also advanced to the fund.

The principal sources of the fund's income have been profits on foreign exchange transactions, interest on foreign exchange swap transactions, and on investments held by the fund, including interest earned on fund holdings of U.S. Government securities.

The amounts reflected in the 1995 and 1996 estimates entail only projected net interest earnings on Exchange Stabilization Fund (ESF) assets. The estimates are subject to considerable variance, as the amount and composition of assets can change dramatically, as well as interest rates applied to investments. In addition, exchange rate fluctuations can cause the dollar value of income received on foreign currency and SDR investments to fluctuate. Moreover, estimates make no attempt to forecast valuation gains or losses on SDR holdings or realized gains or losses on foreign currency holdings. As required by Public Law 95-612, the fund no longer is used to meet the administrative expenses.

Statement of Operations (in thousands of dollars)

Identification code 20-4444-0-3-155		1993 actual	1994 actual	1995 est.	1996 est.
0101	Revenue	1,373,266	1,326,398	1,300,000	1,320,000
0102	Expense				
0105	Net income or loss (-)	1,373,266	1,326,398	1,300,000	1,320,000

Balance Sheet (in thousands of dollars)

Identification code 20-4444-0-3-155		1993 actual	1994 actual	1995 est.	1996 est.
	ASSETS:				
	Federal assets:				
1101	Fund balances with Treasury	16,341,884	16,091,093	16,650,175	17,283,775
	Investments in US securities:				
1102	Treasury securities, par	5,636,690	7,325,760	7,631,330	7,921,730
1106	Receivables, net	17,704	27,095	27,270	28,258
1206	Non-Federal assets: Receivables, net	132,146	148,808	154,529	160,609
1801	Other Federal assets: Cash and other monetary assets	9,202,914	9,371,202	10,406,360	10,802,360
1999	Total assets	31,966,838	33,563,768	34,869,664	36,196,582
	LIABILITIES:				
2104	Federal liabilities: Resources payable to Treasury	14,967,501	15,207,400	15,799,200	16,400,417
2201	Non-Federal liabilities: Accounts payable	50,365	53,019	55,094	57,190
2999	Total liabilities	15,017,866	15,260,439	15,854,294	16,457,607
	NET POSITION:				
3200	Invested capital	200,000	200,000	200,000	200,000
3300	Cumulative results of operations	16,748,972	18,103,269	18,815,370	19,538,975
3999	Total net position	16,948,972	18,303,269	19,015,370	19,738,975
4999	Total liabilities and net position	31,966,838	33,563,768	34,869,664	36,196,582

Intragovernmental funds:

WORKING CAPITAL FUND

Program and Financing (in thousands of dollars)

Identification code 20-4501-0-4-803		1994 actual	1995 est.	1996 est.
	Program by activities:			
00.01	Direct operating program	2,341	4,322	3,946
00.02	Administrative overhead	472	874	796
00.10	Direct operating program	97,578	186,622	164,495
00.11	Administrative overhead	1,367	2,754	2,520
10.00	Total obligations	101,758	188,582	172,360
	Financing:			
68.00	Budget authority (gross): Spending authority from offsetting collections	101,758	188,582	172,360
	Relation of obligations to outlays:			
71.00	Total obligations	101,758	188,582	172,360
	Obligated balance, start of year:			
72.10	Receivables from other government accounts	-133	-877	-877
72.90	Unpaid obligations, fund balance	78,818	92,158	92,158
	Obligated balance, end of year:			
74.10	Receivables from other government accounts	877	877	877
74.90	Unpaid obligations, fund balance	-92,158	-92,158	-92,158
87.00	Outlays (gross)	84,186	188,582	172,360
	Adjustments to gross budget authority and outlays:			
88.00	Offsetting collections from Federal sources	-101,758	-188,582	-172,360
89.00	Budget authority (net)			
90.00	Outlays (net)	-17,572		

Certain central services in the Department of the Treasury, including telecommunications, printing, reproduction, computer support/usage, personnel/payroll, procurement information, and printing procurement services, are provided on a reimbursable basis. Transactions are entered into with other Treasury appropriation accounts at rates which will recover the fund's operating expenses, including accrual of annual leave and depreciation of equipment. This presentation includes the Digital Telecommunications System (DTS), the

PREPARED STATEMENT OF STEVE H. HANKE, Ph.D.

PROFESSOR OF APPLIED ECONOMICS, JOHNS HOPKINS UNIVERSITY, MARYLAND

MARCH 9, 1995

The Question

When considering spending taxpayers' money, we must ask: Where is the money going and will it be used constructively? I will address these questions as they relate to the so-called Mexican bailout.

Background

Exchange rates come in three varieties: floating, fixed, and pegged.

Let's start with floating. That's what the United States uses, allowing the dollar to seek its own levels in relation to other currencies.

Fixed exchange rates are favored by a handful of emerging countries—most notably, Argentina, Estonia, Hong Kong, and Lithuania. These countries employ currency-board-like systems in which the local currency is backed 100 percent by a reserve currency and is freely convertible into the reserve currency at a permanently fixed rate. A country operating under this discipline forgoes an independent monetary policy and becomes part of a unified currency area with the country to which its local currency is linked.

As Nobelist Milton Friedman concluded over 30 years ago, fixed and floating regimes appear to be quite different, but in reality they are both free market mechanisms for international payments.

The third form of exchange rate is the pegged type. It is widely used in emerging countries, and unlike the other two, it is not a free market mechanism. A pegged regime is an interventionist system. It requires a central bank to simultaneously manage the exchange rate and domestic liquidity. This is a tricky, if not impossible, task. Indeed, a pegged rate inevitably results in contradictory policies that invite a speculative attack. When under siege, a peg cannot last unless interest rates are raised to sky-high levels or foreign exchange controls are imposed.

Before December 22, 1994, Mexico had a pegged exchange rate system. It blew out because domestic liquidity was increasing much more rapidly than was consistent with Mexico's pegged exchange rate. In consequence, a relatively large current account deficit was realized and it was being financed by an involuntary run down in the central bank's foreign reserves. This type of run down is the stuff of balance of payments crises. The run down in reserves caught the markets off guard because the Bank of Mexico wasn't publishing reserve figures on a timely basis. However, once the figures started coming out the bears went to work on the peso and a classic balance of payments crisis ensued. We all know the rest of the story.

The Current State of Affairs

The Mexicans are now operating with a floating rate system. It is a dirty float because the central bank is using credit lines to borrow dollars that are then used to buy pesos. Thus, part of the bailout money is being used to prop up the peso.

Now, in principle, floating systems are sound, free market systems. However, a floating system is not appropriate for Mexico because its central bank has little credibility. Indeed, even before the events of December 1994, it was classified as one of the world's worst central banks, at least in terms of producing stable money. By one reckoning, it ranked 101 out of 108.

With little credibility and a floating exchange rate system, Mexican interest rates will have to be very high for a number of years. This will severely depress the Mexican economy. And, perhaps more importantly, it will force many borrowers to default on their loans. Consequently, Mexico will face a very severe banking crisis in the very near future. The government will be forced to nationalize the banks and recapitalize them.

Conclusion

With the current Mexican exchange rate system, taxpayers' money is being used in a futile attempt to prop up the peso. As soon as the Mexican banking crisis takes hold, the taxpayers' money will be used to nationalize and recapitalize a failed banking system. To put this eventuality into perspective, consider that the recent Venezuelan banking crisis and government bailout cost Venezuela about 13 percent of its GDP. Compare this to our S&L bailout, which cost us approximately 4 percent of our GDP. In Mexico, I believe we will see magnitudes close to those realized in Venezuela.

Allow me to close, by asking whether you think the U.S. taxpayers will be pleased

AS WE SEE IT

The Mexican peso is seriously overvalued. This overvaluation threatens the success of an otherwise commendable program of economic reform.

The wobbly peso

BY STEVE H. HANKE & SIR ALAN WALTERS

Steve H. Hanke is a professor of Applied Economics at The Johns Hopkins University in Baltimore and Sir Alan Walters is vice chairman of AIG Trading Group, Inc. in Washington, D.C.

ALTHOUGH Ernesto Zedillo, candidate of Mexico's long-dominant Partido Revolucionario Institutional (PRI), holds a narrow lead in polls for the Aug. 21 presidential election, he is being dogged by candidates from two other parties in an increasingly turbulent contest, which has already seen Luis Donaldo Colosio, PRI's first candidate, assassinated. Cuauhtemoc Cardenas, the Partido Revolucionario Democratico's (PRD) candidate, claims that he has received death threats.

All this political turmoil comes on top of a dicey economic situation. The economy was in a state of stagnation, with a meager growth rate in 1993 of 0.4%, long before the election campaign got under way. And 1994's first quarter shows little promise of recovery. This is a great disappointment to all of us who cheered the reforms that were begun in the last years of de la Madrid's presidency and much accelerated by President Salinas.

Mexico has accomplished much. It has substantially opened its economy to world trade, reduced regulation, privatized much of its state sector, reduced the fiscal deficit to less than 2% of GDP and finally made the Central Bank independent of government. Consequently, inflation has been reduced from more than 22% in 1991 to 7% in 1994. However, in spite of a recovering U.S. economy, Mexico's reforms have delivered miserable real growth.

What has gone wrong? We believe that the critical error of policy was in pegging the peso to the dollar. The Mexican authorities have undertaken to peg the peso today at about 3.3 pesos to the dollar with a tolerance band of some plus or minus 3%. The peg is allowed to "crawl" so that the permitted band is moved downward by 0.0004 pesos a day. Thus the allowed maximum depreciation per annum is about 0.15 pesos, or 4% per year.

The rationale for pegging the peso to the dollar was to combat the inflation that the government had inherited. The peg was to provide a "nominal anchor" for the peso that would eventually usher in rates of inflation more or less the same as in the U.S. However, in the interim, the rate of inflation in Mexico has exceeded the U.S. rate of inflation. This inflation gap exceeds the peso depreciation allowed by the crawling peg. Consequently, the peso has become increasingly overvalued.

An overvalued peso puts a direct squeeze on Mexico's export industries and assists foreigners selling goods to Mexicans. The swelling deficit on the current account of the balance of payments is evidence of this effect. This deficit must be financed by net capital imports or, more ominously, by running down official foreign exchange reserves.

Persuading portfolio holders to keep their peso-denominated bonds and bills has been a major task so far and, we suspect, will become all but impossible as we approach the Aug. 21 election. The peg is becoming less and less credible. Consequently, the likelihood of a large movement in the peg (at least 10%) induces many a watchful portfolio holder to sell his peso bonds and buy the security of dollar-denominated government Tesobonos. This capital flight can be contained only by massive increases of peso interest rates. Sure enough: In secondary markets interest rates have risen to 25% per annum. Of course, such interest rate hikes add to the woes of industries already weighed down by an overvalued peso. Indeed, the peg's punishing interest rates guarantee that the recession will continue.

Other ways of containing the pressure of capital flight have also been put into place—most noticeably the "swap" facility of $6.73 billion, which was recently agreed upon by the signatories of Nafta. This will no doubt help delay the day of reckoning—but it is a delay, not a settlement. As with all such lines of credit, they come to an end much quicker than anticipated.

It has been said that the peso cannot conceivably be devalued before the election. Certainly the government will do all in its power to avoid such a contingency, but we are skeptical about its chances for holding the peg. The power of world capital markets to undo even the best-laid plans of presidents and central bankers has been demonstrated quite dramatically in Europe in these 1990s.

Mexico can do one of two things—and the sooner the better. As Britain did in 1992, when sterling was unpegged from the deutsche mark, Mexico could float the peso. Alternatively, Mexico could follow Argentina's 1991 currency reform and install a currency board-like system. Under that setup, the peso would be fully backed by U.S. dollar reserves and freely convertible at a permanent fixed rate of 4 pesos to the dollar, which represents about a 16% devaluation from current levels.

If Mexico retains its half-baked peg, the Mexican economy will continue to disappoint and investors will be in for a wild roller-coaster ride. It is only by floating or fixing the peso exchange rate that Mexico will deliver in spades the potential promised by its Thatcher-Reagan type reforms. ■

POINT OF VIEW

Before investing in an emerging market, find out about the country's exchange rate system. Be careful of those with pegged currencies.

Arbitrage in Argentina

BY STEVE H. HANKE

Steve H. Hanke is a professor of Applied Economics at The Johns Hopkins University in Baltimore.

YES, INDEED, investors should aggressively pursue the opportunities served up by the emerging markets. There's just one caveat: These markets are volatile. You can get creamed if your timing is off.

How do you avoid a timing mistake in an emerging nation? By paying anxious attention to its monetary policies. Since these policies are dictated in large part by the type of exchange rate regime employed, you should begin by understanding the mechanics of the alternative approaches.

Exchange rates come in three varieties: floating, fixed and pegged.

Let's start with floating. That's what the U.S. uses, allowing the dollar to seek its own levels in relation to others. Most major currencies float, but not one of the emerging countries allows its currency to float.

Fixed exchange rates are favored by a handful of emerging countries—most notably, Argentina, Estonia, Hong Kong and Lithuania. These countries employ currency-board-like systems in which their local currencies are backed 100% by a reserve currency and are freely convertible into the reserve currency at a permanently fixed rate. A country operating under this discipline forgoes an independent monetary policy and becomes part of a unified currency area with the country to which its local currency is linked.

As Nobelist Milton Friedman concluded over 30 years ago, fixed and floating regimes appear to be quite different, but in reality they are both free-market mechanisms for international payments. They limit the amount of control a government can have over its currency.

The third form of exchange rate is the pegged type. It is widely used in emerging countries, and unlike the other two, it is not a free-market mechanism. A pegged regime is an interventionist system. It requires a central bank to manage simultaneously its currency's exchange rate, the domestic liquidity and the capital account. This is a tricky, if not impossible, task. Indeed, a pegged rate inevitably results in contradictory policies that invite a speculative attack. When under siege, a peg cannot last unless interest rates are raised to sky-high levels or foreign exchange controls are imposed. Alas, such episodes usually get out of hand and play havoc with markets.

When President Carlos Menem was elected in 1989, Argentina had a pegged exchange rate and its economy was in a shambles: Annual inflation was 3,080%; economic growth was negative; capital flight was endemic. To gain the credibility required to liberalize the economy, Menem had to break the back of hyperinflation.

Under the watchful eye of Argentina's minister of economy, Domingo Cavallo, a currency-board-like system with a fixed exchange rate was introduced on Apr. 1, 1991. This was apparently influenced by the monograph I wrote with my postdoctoral fellow, Kurt Schuler, in late 1990, *Banco Central o Caja de Conversión?* Since then, the peso has been fully backed by U.S. dollar reserves and freely convertible at a 1-to-1 exchange rate with the greenback. Argentina is now part of the dollar currency bloc.

Once exchange rates are firmly fixed, inflation and interest rates must converge among the countries whose currencies are in a fixed relation to each other. Thus Argentinean inflation rates dropped toward U.S. levels. Arbitrage saw to it. Argentina's annual inflation has fallen steadily since 1991 and will close the year at 3.6%, only about 1% higher than the U.S. rate.

Interest rates are another story. Argentina's interest rates remain much higher than those in the U.S.: Argentinean peso treasury bills yield about 9.5%, and government paper that matures in seven years yields an incredible 16.75%. Comparable U.S. yields are about 5.3% and 8%, respectively.

Why this wide spread? If the peso is almost as good as the U.S. dollar, shouldn't Argentinean interest rates be about the same as ours?

There are valid and invalid reasons for the difference. It takes more than a strong currency to make a strong

Both fixed and floating systems limit the amount of control a government has over its currency.

debtor, and Argentina isn't as reliable as the U.S. Next, the cost of obtaining information about the Argentinean paper is higher, at least for investors outside Argentina, than for U.S debt. Then there is a reason much less valid than the other two—a fear that the currency board will be abandoned and the peso devalued. This fear is unfounded.

On balance, the yawning gulf in interest rates cannot be justified. To put it in other words, Argentinean peso T bills and bonds are irresistible buys right now. ■

POINT OF VIEW

The collapse of the Mexican peso has created an opportunity for investors, but in Argentina, not in Mexico.

Pegged out

BY STEVE H. HANKE

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MEXICO'S is the latest economy to fall victim to the International Monetary Fund. The week before Christmas the peso lost almost 30% of its value and Mexican stocks and bonds suffered a major drubbing.

These events should not have caught FORBES readers entirely by surprise. Late last spring Sir Alan Walters and I visited Mexico City to discuss the peso. In our column "The wobbly peso," dated July 4, 1994, we warned our readers that, because of Mexico's IMF-imposed pegged exchange rate system, investors in that country were in for a wild ride. We flatly predicted: "If Mexico retains its half-baked peg, the Mexican economy will continue to disappoint." Unfortunately for investors, we were right.

Under the pegged system, the peso was linked to the U.S. dollar. The peso was allowed to trade within a tolerance band of some plus or minus 3%. The band "crawled" downward daily, allowing an annual peso depreciation of about 4% against the dollar.

To keep the peso within this band, the Mexican central bank had to manage simultaneously both the peso-dollar exchange rate and the peso money supply. This is an almost impossible balancing act, as members of Europe's Exchange Rate Mechanism (a pegged system) discovered in 1992 and 1993. Pegged systems inevitably result in contradictory policies that invite speculative attacks and exchange rate realignments.

Instead of a pseudo-fixed exchange rate, with its accompanying pseudo-monetary policy, Mexico would have been much better off with a currency board-like system, such as the one employed in Argentina. Under that setup, Argentina's peso freely trades for the U.S. dollar at an absolutely fixed 1-to-1 rate. The ratio is credibly maintained by requiring that all pesos be fully backed with dollars—just as currencies were backed by gold during the "classical" gold standard period (1880-1914).

But with pegged rates, the peg is only as good as a government's promise to maintain it, a promise that events throughout the world have shown to be lacking in credibility.

For the moment, the Mexican peso is floating freely, and where it will land, no one can tell. The government has announced that it will be allowed to float for 60 days until it finds a new level. But it is a safe bet that when the peso does settle down, Mexico will again bow to the IMF and adopt a new pegged rate.

What, then, should investors do? Mexican security prices have been pounded. But are Mexican stocks and bonds a buy now?

I fear not. Mexico, thanks to the IMF and its cheerleaders in the U.S. Treasury, has lost something that will take years to rebuild: investor confidence. Considering what has happened in recent weeks, it will be a long time before investors will again believe what the Mexican government tells them.

Consider that on Nov. 20, 1994 President-elect Ernesto Zedillo, for the third time since his election, promised to hold the peso peg; on Dec. 1, during his inaugural speech, he again made a peg pledge; and on Dec. 9 his finance minister presented Mexico's 1995 budget to the Mexican congress and promised to defend the peg come hell or high water.

Will future policy pronouncements by government officials be taken seriously? Not likely.

Lost credibility represents only part of Mexico's woes. The country faces $56 billion of debt coming due in 1995. This includes $20 billion that must be rolled over in the next 100 days. Much of the debt, though denominated in pesos, is convertible to dollars at the choice of the lenders. If lenders choose to be paid in dollars and/or refuse to pony up new credits, the dwindling Mexican dollar reserves (about $6.5 billion) and credit lines from the U.S. and Canadian governments ($7 billion) will be overdrawn. It's no wonder that Standard & Poor's has placed Mexico on the negative credit watch. Indeed, a 1980s-like Mexican default is a possibility.

To avoid such a fate, Mexico will probably turn to the IMF and the U.S. government for additional funds. This, of course, will force the Mexicans into an even tighter embrace by the folks who assisted in engineering the current mess. It will also probably rule out the only real solution to

By submitting to the IMF, Mexico more or less assures itself more trouble down the road.

Mexico's currency problems: a currency board and a monetary unit fully backed with hard currency.

The Mexican meltdown sent all the Latin markets spiraling down as fund managers indiscriminately dumped securities throughout the region. Argentina's peso was unscathed, but its markets weren't spared. And therein lies the opportunity. In my Dec. 19, 1994 column I said that Argentinean peso T bills and bonds were irresistible buys. Well, they are even more irresistible now. And I would add Argentinean floating-rate, dollar-denominated Brady Bonds to that list. Argentina is not Mexico. ■

POINT OF VIEW

Mexico could have avoided the peso crisis if it had had a currency board.

Jobs for the boys

BY STEVE H. HANKE

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THE International Monetary Fund was established in 1944 to provide short-term assistance to countries whose currencies were pegged to gold or the U.S. dollar. This rationale disappeared when the major currencies were floated after the U.S. went off gold in September 1971. But bureaucracies that outlive their purpose never fade away. Indeed, the IMF assumed new powers and kept growing.

The IMF kept growing by insisting that developing countries put central banks in charge of money creation. These central banks don't work well. They produce lousy money. But never mind. That creates more patronage for the boys at the IMF because they have to monitor and bail out the troubled central banks. The IMF also costs the taxpayers dearly.

Most developing countries are plagued by relatively high rates of inflation because their central banks emit excessive amounts of money. Among the 126 developing countries monitored by the IMF, the average annual rate of inflation was 20.2% from 1971 to 1983 and 43.5% from 1984 to 1993.

In addition to expropriating wealth by inflation most central banks in developing countries curb individual freedom by limiting convertibility, that is, restricting people's ability to exchange third-rate currencies into first-rate currencies. To the extent the central banks succeed, they create a fence inside which their citizens' money and property can be expropriated through inflation.

If this situation weren't bad enough, most central banks in developing countries are encouraged by the IMF to employ pegged exchange rate regimes, i.e., to link the value of their currency to a stronger one. This is supposed to produce sound money and confidence. But it doesn't because the link always breaks. Consequently, as I pointed out in my Jan. 16 column on Mexico, pegged exchange rates invariably generate balance-of-payments crises, devaluations and—you guessed it—more IMF jobs.

There is a better way to provide money in developing countries, but most governments shun it because that way makes it impossible to print money to finance government deficits. The alternative is a currency board system.

A currency board cannot print money at will. Indeed, it can only issue notes and coins to the extent that the new money is fully backed by hard currency reserves.

Unlike central banks, currency boards have never devalued against or suspended convertibility into their anchor currency.

This 100% hard currency backing provides credibility for a permanently fixed rate of exchange between a board's money and its reserve currency. A board cannot expand the monetary base faster than it obtains foreign reserves. Therefore, a Mexican-style balance-of-payments crisis—which is set off when a country's foreign reserve cover sinks close to the vanishing point—cannot occur.

Currency board systems are well tested. They have existed for almost 150 years. There have been some 70-plus currency boards. In *Russian Currency and Finance* (1993), Professor Lars Jonung, Dr. Kurt Schuler and I show that, unlike central banks, currency boards have never experienced a balance-of-payments crisis, devalued against or suspended convertibility into their anchor currency.

Most currency boards were replaced with central banks in the 1950s and 1960s because of intellectual fashions and pressure from the IMF. Some boards survived, most notably Hong Kong's—with commendable results. Since 1991 I have had a hand in establishing currency boards in Argentina, Estonia and Lithuania. They have successfully crushed inflation, promoted fiscal discipline and stimulated economic growth. In Argentina, for example, annual inflation was 2,315% in 1990. On Apr. 1, 1991 President Menem thumbed his nose at the IMF and installed a currency board. Now Argentina has the lowest rate of inflation in Latin America (3.9%), a balanced budget and close to 7% growth.

Mexico and Russia, two IMF basket cases, ought to take note. In addition to providing Mexico and Russia with sound currencies, currency board systems would provide both countries with a transparent institution, so that the public could see what was going on with the currency. Everyone could see the exchange process taking place. There would be no need to guess the intentions of politicians and bureaucrats; both would have their larcenous hands tied.

Already Mexico is under pressure to report its foreign reserve holdings on a more frequent basis. (With a currency board it could report reserves daily, as does Argentina.) Will the Mexican politicians accept a currency board system? Maybe. The Mexican central bank is currently studying the idea.

There are only three losers in a currency board system: Central bankers and IMF people who will lose their cushy jobs; and politicians who will lose some of their ability to expropriate people's savings. ■

POINT OF VIEW

With every international financial crisis there is yet another opportunity for the bureaucrats at the IMF to justify more socializing of speculators' risks.

Bob Rubin, meet C.N. Parkinson

BY STEVE H. HANKE

Steve H. Hanke is a professor of Applied Economics at The Johns Hopkins University in Baltimore.

THE MEXICAN PESO debacle of Dec. 20 caught the International Monetary Fund asleep at the wheel. Indeed, the IMF's early warning system completely failed to detect trouble on the horizon.

It didn't take the IMF Hydra long to wake up, though. The fund's managing director was quick to spin a tale to justify—you guessed it—more money and more power for the IMF. Not surprisingly, Michael Candessus' vision was supported by Bill Clinton's new Treasury Secretary Robert Rubin.

All this lobbying activity caused me to pull *Parkinson's Law* (1957) from my bookshelf. In this classic we find that the British Admiralty augmented its personnel by almost 79% from 1914 to 1928, even though the number of combat ships under its command fell from 62 to 20 and total crew personnel declined by almost one-third.

As clever as the British Admiralty was, its record of self-promotion can't hold a candle to that of the IMF. The IMF was established as part of the 1944 Bretton Woods Agreement. Its primary purpose was to extend short-term, subsidized credits to countries that were experiencing balance-of-payments problems under the Bretton Woods exchange rate system. These credits served to finance foreign exchange interventions, in the hope that competitive devaluations and trade frictions could be avoided.

When the Bretton Woods system collapsed in 1973, it seemed that the IMF would likewise fall. Its original justification no longer existed. The IMF had become an empty shell. One of my mentors, Professor Jürg Niehans, the distinguished Swiss economist, thought the IMF's passing timely because he had demonstrated that the IMF's lending activities had been unnecessary and even counterproductive.

The obituary was premature. The 1973 OPEC oil embargo allowed the IMF to reinvent itself. More lending was "required" to cushion the oil price shock. And more lending there was: From 1970 to 1975 IMF lending more than doubled in real terms. Assisted by the second oil shock of 1979, the IMF kept pumping out new cushioning loans into the early 1980s, albeit at a slower rate. From 1975 to 1982 loans increased by another 58% in real terms.

With the election of Ronald Reagan in 1980, it looked as if the glory days of the IMF might come to an end. The Administration favored a restrictive course for IMF lending. The Mexican debt crisis of 1982 changed all of this. The IMF Hydra moved quickly to argue that it should provide more lending in order to avert an international financial crisis.

Remember, the IMF charter contains no provision for such lending. But never mind. The IMF scored again. Indeed, Ronald Reagan proclaimed that he had personally lobbied 400 out of 435 congressmen to obtain approval for a U.S. quota increase for the IMF. The IMF put those new funds to work at once. From 1980 to 1985 IMF lending increased by 27% in real terms. This lending was, of course, little more than a bailout of foreign banks that were overexposed in Latin America.

This brings us to today's Mexican peso crisis. To justify more lending and additional powers, the IMF Hydra has shown us yet another head. Despite the rhetoric about saving the international financial system from a meltdown, the truth is that the IMF will be bailing out investors, mostly Americans, who have speculated in Mexican stocks and bonds. No wonder the Europeans are less than enthusiastic.

It's time to take a serious look at the IMF's operations. This is not an easy task. To protect itself from outside scrutiny, the ever-secretive IMF makes its adjustment programs with debtors confidential. This secrecy serves the IMF well because it conceals the ineffectiveness of the conditions it claims to impose upon its borrowers.

Evaluating the IMF will, therefore, take a while. In the meantime, there is no need to pump any more money into its coffers, which are lined with hidden reserves. The IMF holds 103.4 million ounces of gold, which it values at $51.50 per ounce, for a total book value of approximately $5.3 billion. At today's market prices, the IMF's gold hoard is worth almost $39 billion. This amounts to a cool $33.7 billion in hidden reserves. Consequently, there is no good reason for Congress to succumb to the IMF's panhandling.

For all its posturing as the savior of free markets, the IMF is nothing more than an interventionist monster for socializing risks. Let investors take their own risks for a change. ■

Despite the rhetoric about financial meltdown, the truth is that the IMF will be bailing out investors.

THE WALL STREET JOURNAL WEDNESDAY, FEBRUARY 22, 1995

Critics Err — Mexico Still Needs A Currency Board

By STEVE H. HANKE

The Mexican and U.S. governments have repeatedly fumbled since the peso debacle began in late December. The bailout package announced yesterday is no exception. It will send the Mexican economy into a tailspin and set back U.S.-Mexican relations for decades.

The conditions placed on the bailout will require the Mexican money supply to be put on a short leash held by officials in Washington. This smacks of the "Roosevelt Corollary" to the Monroe Doctrine, articulated in 1905 by Theodore Roosevelt and used to justify the U.S. taking all steps necessary, short of territorial aggrandizement, to protect its position as a Latin American creditor. As readers of this page know, there is a way out of this box: Mexico could design and implement an Argentine-type currency board. Alas, misinformed critics have buried this idea in an avalanche of criticism and confusion:

- Most critics erroneously assume that boards operate like central banks with pegged rates.

This is false. Central bank pegs invariably come unpegged when the central bankers are seduced by calls for devaluation. Mexican pegs have not stood the test of time. The Bank of Mexico already has a poor record of producing stable money. On that score, a recent book by Marjorie Deane and Robert Pringle, "The Central Banks," places the Bank of Mexico 101st out of the 108 central banks reviewed.

With a board, the peso's monetary base (notes and coins) would be solely determined by the free market demand for pesos, at a permanently fixed exchange rate. The base would not be determined by the Bank of Mexico, regardless of whether it was operating independently or under the watchful eye of the U.S.

If implemented properly, a currency board would lower inflation and interest rates, because Mexico would be part of a unified currency area with the U.S. Former Fed Chairman Paul Volcker understands this. In July 1994 he wrote that, by and large, currency boards have outperformed central banks on price stability.

Central banks in developing countries are subject to periodic balance-of-payments crises. Mexico's recent experience is a classic case. Last year, it was experiencing a relatively large current account deficit, which was, in part, being financed by the Bank of Mexico running down its foreign reserves. Once the currency speculators sensed that the central bank was desperately low on reserves, they blew the peso peg out.

Such a crisis cannot occur with a currency board. Indeed, no currency board has ever experienced a balance-of-payments crisis, because the holders of currency board notes and coins own a board's foreign reserves. Consequently, reserves cannot be used by the government to involuntarily finance a current account deficit. Boards have existed for over 150 years and have been employed in over 70 countries. No board has ever devalued its currency against its anchor currency.

- Many—including Ariel Buira, deputy governor of the Bank of Mexico—erroneously claim that a currency board would be too costly to implement.

To establish a currency board, the peso's monetary base would have to be fully backed by a reserve currency, such as the U.S. dollar, and the peso would have to be fully convertible at a permanently fixed rate to the dollar. With Mexico's current monetary base and a fixed rate of 6 to 1, roughly the current peso-dollar rate, about $11 billion would be required.

Admittedly, the Mexicans don't have this level of reserves in hand. But under the U.S. Foreign Operations, Export Financing and Related Programs Act of 1993, the International Monetary Fund is authorized to lend Mexico the reserves to establish a currency board. Moreover, the Mexicans could pay off the loan with the difference between the interest earned on the

reserve assets and the fact that no interest would be paid on its liabilities.

Currency boards have always maintained full convertibility, even during civil wars. By contrast, though the peso is currently convertible, Mexico has a long history of restrictions. To the extent that such restrictions succeed, they create a fence inside which citizen's money and property can be expropriated through inflation created by the central bank.

Moreover, in contrast to the ever-secretive central banks, currency boards are simple, transparent institutions. Indeed, Argentina's currency board publishes its foreign reserve position on a daily basis. There is no need to guess the intentions of politicians and bureaucrats who, in any event, would have their larcenous hands tied by a rule-bound monetary constitution. A currency board's bookkeeping is simple and its balance sheets are straightforward. Even under the most trying conditions, currency boards have been free from scandal and graft. If Mexico wants transparency, which it desperately needs, there is only one way to go.

• Without defining their terms, some critics claim that, the merits of a currency board notwithstanding, Mexico is too large to have one.

This argument is curious, as Argentina's economy is roughly the same size as Mexico's, in terms of the dollar value of their gross domestic products, at current exchange rates. And Argentina's currency board has worked well. Currently, the rate of inflation in Argentina is 3.9%, the lowest in Latin America, the budget is virtually balanced, and growth is close to 7%.

If properly designed and implemented, a currency board system would produce stability in Mexico—a much needed first step in Mexico's economic liberalization. Indeed, Karl Schiller, West Germany's finance minister between 1966 and 1972, got it right when he said "stability might not be everything, but without stability, everything is nothing."

Mr. Hanke, a professor of applied economics at Johns Hopkins University in Baltimore, is the author, with Kurt Schuler, of "Currency Boards for Developing Countries" (ICS Press, San Francisco, 199?).

PREPARED STATEMENT OF RALPH NADER

CONSUMER ADVOCATE, WASHINGTON, DC

MARCH 9, 1995

Mr. Chairman and Members of the Committee, thank you for the opportunity to testify about the Mexican bailout debacle. While this hearing will cover recent events leading to the bailout, our focus should be on how to extract the United States from this international entanglement before it gets worse.

The important issue presented here today goes beyond this particular bailout, although stopping it would save taxpayer money and discourage the United States from shouldering other foreign wards of the state in the future. It is necessary to recognize the scope of the crisis precipitated by the Mexican government and compounded by the U.S. Government—especially their Executive Branches. Mexico is a clear forewarning of the dangers and the failures of the multinational corporate development model that Mexico and so many other developing countries are following.

In fact, Mexico was the quintessential model pushed by the International Monetary Fund and many U.S. Government leaders. Treasury Secretary Robert Rubin has made this point repeatedly, telling Congress the United States had to bail out the corrupt Mexican regime because it was a model for so many other emerging markets. This is extraordinary logic! It is precisely because Mexico was the prototype for a failed model that this Congress needs to act now to head off future losses.

Too much of the hot money that poured into Mexico in recent years was an act of speculative faith that failed to appreciate the shaky foundations on which the Mexican "miracle" was based. The same is true for the North American Free Trade Agreement, which was an agreement that the U.S. Government made with a Mexican government that was unworthy of such a partnership for economic integration. Congress can act decisively to cut looming U.S. losses associated with bad policies or it can shut its eyes and pursue those policies to a crisis of a much greater magnitude for the citizens of the United States and Mexico. This Committee should begin work immediately to forge a plan for constructive *disengagement* from the failed economic model that the Mexican government pursued so devoutly.

Congress should not overlook that the Mexican government and NAFTA represent the same anti-democratic, trade *uber alles* model of economic globalization that undergirds the Uruguay Round of GATT's World Trade Organization. What are the defining characteristics of this "new global financial system" whose survival, Administration officials repeatedly have claimed, depends on this bailout? Who set it up and who oversees it? Who are its winners and losers? And who has cast the United States in the role of the economic super glue required to mend its fraying edges?

If we heed the larger lessons of this Mexico debacle, it could save us from a much larger and more geographically far-flung recurrence of the same problems. The U.S. economy cannot survive as the banker of last resort for the world nor as the errand boy for the multinational corporations and financial institutions that have promoted this uncontrolled system for their own benefit. If the United States continues to pursue this course of global economic dependency on the United States it could precipitate our country's further decline in standards of living for most Americans. The alternative to a downward spiral of dependency and bailouts, however, does not lie in economic or political isolation. Rather, we must develop a new strategy, based on strengthening our domestic market, our domestic democracy, and a policy of pull-up international trade agreements, not pull-down agreements, with other countries.

Peso Post-Mortem

It is indefensible that the Clinton Administration circumvented Congress to obligate more than $20 billion in taxpayer funds that were set aside to stabilize the U.S. dollar in order to bail out Wall Street investors and Mexico's corrupt ruling class. The bailout scandal, however, goes far beyond this aggressive and constitutionally dubious mining of the Exchange Stabilization Fund (ESF) by the Administration. Congress should act decisively on a broad range of issues to structure a preventative set of policies to replace unbridled Executive Branch discretion to create a disaster.

1. *Hold Accountable Those Who Knew and Deceived the Public*

The same Government officials and Wall Street collaborators who came to this Congress in an atmosphere of contrived panic in January to demand that Congress appropriate $40 billion for Bailout I knew or should have known much more about the risks inherent in Mexico than they have acknowledged. They knew that the peso had been overvalued and knew the risks of misrepresenting the peso's strengths. They knew of Mexico's economic and political instability and concealed this informa-

tion from Congress and the public to secure passage first of NAFTA and then of the Uruguay Round of GATT. They must be held accountable.

In a sense, Congress is on trial before the American people to determine whether it can perform as an independent branch of Government by holding responsible those Government officials who, over the past 2 years, have portrayed the dictatorial and monopolistic Mexican political economy as a sound and stable investment for the United States—even though this portrayal was a costly mirage.

These officials knew of the inherent instability of a political dictatorship that has long run rife with the corruption of its super-oligarchs, its repression of its workers and its citizens, and its unenforced paper laws. Now, the whole world has glimpsed Mexico's tawdry political world, as new rumors and charges surface daily about how leaders of Mexico's perennially ruling party have been implicated in crimes, judicial coverups, and the exploitation of public offices to amass enormous fortunes.

U.S. officials also knew of the overvalued peso and Mexico's history of politically timed devaluations. They knew of the movement of capital flight, the vast enrichment of a new class of mega-billionaires, and the secret initiatives by Washington during the NAFTA debate to shore up the peso. Yet, notwithstanding this knowledge, they deliberately continued to paint a rosy scenario, in order to pass NAFTA and to *assure*, as U.S. Trade Representative, Mickey Kantor, told us in a meeting before the NAFTA vote, that the existing regime remains in office following President Salinas. While repeatedly portraying NAFTA's first year as an unprecedented success on both sides of the border, the Administration's shallow propaganda neglected to inform Congress, not to mention the public, that Mexico's foreign hard currency reserves were perilously low.

2. *The Bailout Is a Bust*

Despite the White House's $50 billion back-door bailout, the Mexican economy, which has fundamental problems that go well beyond a cash-flow problem, continues to implode. Billions of dollars have been extended to Mexico's government—without any credible plan to solve that country's economic nose-dive toward depression.

The Mexican government already has been forced to take over the first round of the country's weakest banks; many more are teetering in the wings. Mexican companies are laying off large numbers of workers, who have been subjected to yet another PACTO that caps their wage increases to 7 percent this year. Meanwhile, interest rates have cleared 50 percent and inflation is expected to exceed early predictions of 20 to 25 percent.

Mexican citizens are protesting the crash in their standards of living with mass protests in the streets. With all elements of the back-door bailout now approved—ESF, IMF, and the Bank for International Settlement—the peso dropped to a new low this week.

Because of NAFTA, all three signatory countries are facing economic difficulties as a result of the Mexican government's mismanagement of its economy. The United States has directly obligated itself to $20 billion, plus more billions via the depleted IMF—both of which funds will be, no doubt, the subject of a replenishment request by the White House to Congress soon. *New York Times* columnist Thomas Friedman summed it up in his March 8, 1995 column, "Mexican Malfunction," from Mexico City. "So far all that has happened is this: Foreign bondholders are cashing in their bonds for pesos as soon as they reach maturity, then they are taking those pesos to the banks here, changing them immediately into dollars, and taking them back across the Rio Grande," Friedman writes. "The banks are getting the dollars to pay the foreigners from the Mexican government, and the Mexican government is getting the dollars on loan from the U.S. Treasury. This is not a pretty picture." It is the U.S. taxpayer, of course, who is ultimately funding this scheme, shifting more wealth from the many to the few.

3. *The U.S. Dollar Is Being Dragged Down*

As predicted by business critics of the bailout such as William Seidman and Christopher Whalen, the world markets have interpreted the U.S. bailout as a step toward a *de facto* currency union between the United States, Canada, and Mexico. This is one of several important factors that have seriously eroded the U.S. dollar in recent weeks relative to the German mark and Japanese yen. In the past 2 weeks, the value of the U.S. dollar relative to that of Japanese yen has declined 10 percent.

David Schulman, chief equity strategist at Salomon Brothers, Inc., released a report Monday in which, according to the March 8 *Washington Post*, he was "glum about what he called the 'open ended' commitment to intervene in Mexico's financial troubles." The report said, "Since the United States has joined the 'peso block,' the U.S. dollar has been weakening against the yen and the Deutschemark." Mean-

while, with most of the ESF earmarked for the Mexican bailout, questions are being raised here and abroad about the U.S. ability to defend its own currency. In trying to calm repeated questions by Members of the House of Representatives at a hearing of the House International Relations Committee this week, Treasury Under Secretary Lawrence Summers hinted that one response may be to get the Federal Reserve to "warehouse" currencies. This Committee should push for greater details about this in tomorrow's hearings with Administration officials.

What has been the response to this growing crisis? Where is Mickey Kantor—the once omnipresent booster of NAFTA and the Salinas–PRI regime? Are officials appropriately questioning whether there is a common source of these currency slides in the very economic model that has linked the three NAFTA countries? Has the Administration taken action to de-link the U.S. dollar from Mexico's economic tar pit? No. Instead, all three countries are tightening their belts. As a guest at the House International Relations Committee hearing Tuesday, House Banking Chairman James Leach, a leading early supporter of the bailout, rightly questioned Administration officials about the connection between NAFTA, the bailout, and the currency slide. But officials failed to provide direct answers. Representative Leach then suggested that a U.S. austerity program might be required to bolster the U.S. dollar. Chairman Leach asked, "Shouldn't the United States reduce public sector spending and reduce its deficit, the same medicine we are suggesting for Mexico?"

4. *U.S. Treasury Funds Are Being Thrown Away*

Despite the increasingly obvious failure of this massive, back-door bailout, the Administration continues to support keeping the entire $20 billion package of swaps, loan guarantees, and outright loans available to the Mexican government. Must we keep pouring good money after bad?

5. *This Debacle Must Be Seen as a System Failure, Not a Fluke*

The underlying disturbance of this debacle is the drive toward an economic union, through NAFTA, of the United States, Canada, and Mexico. NAFTA critics warned again and again in 1992 and 1993 that melding together economies with such profound differences of development and political-legal traditions would be destabilizing on both sides of the U.S.–Mexican border. The differences in economic development have come home to roost with the *de facto* establishment of a North American currency and the threat of U.S. job losses from plants going south to take advantage of a labor pool that, since the devaluation, has become less expensive. The political and legal differences have become glaringly apparent as the facade of the rule of law in Mexico, so carefully orchestrated for the NAFTA push, has been ripped away with daily revelations of high-level political involvement in political homicides, cross-border crimes, and the endemic exploitation of public office for private gain. Privatizations are yet another boost for huge corruption to enrich new Mexican billionaires. Did not the Mexican people bear the brunt of the touted balancing of the budget by Salinas?

How NAFTA's dynamics may have exacerbated Mexico's debt problems and current accounts deficit is not adequately known to Congress or the public. Many NAFTA supporters and opponents do agree, however, that the peso devaluation was repeatedly postponed to the point of crisis in order to promote the passage of NAFTA, GATT, and, finally, the personal ambition of then-President Salinas to head up the new World Trade Organization.

Administratien officials continue to repeat their mantra that the situation would be even worse if it were not for NAFTA. How could it get worse? There is armed revolt in Mexico that has been initiated, in part, as a peasant response to what they denounce as NAFTA's assault on subsistence farming. The Mexican economy is nose-diving and foreign investors have fled. In the one year of NAFTA, the standard of living for most Mexicans has dropped perilously. The United States is losing jobs to Mexico, as documented by our own Department of Labor. The currencies of all three NAFTA countries are sinking. What a contrast to the confident predictions of the White House, the USTR, and their congressional allies.

The one fact the Administration has given to defend its ludicrous assertion that we're better off under NAFTA is that Mexico has not raised tariffs on U.S. products as part of its emergency response to the crisis. Last week, however, Mexico took steps allowed under GATT for balance of payment emergencies to raise tariffs on a variety of goods by 38 percent. NAFTA has similar provisions for emergency tariff increases. Undoubtedly for obvious political reasons, Mexico has acted under the GATT rather than the NAFTA provisions. But nothing in NAFTA prevents such an action. Moreover, with such a large peso devaluation, Mexico has a substitute for tariffs, for a time, at least.

6. *The Administration Must Be Shown a Way Out of Its Dream World*

The Administration's response to this growing crisis with Mexico and NAFTA resembles Alice in Wonderland, with Deputy Treasury Secretary Summers dodging questions about the plummeting dollar and peso to assure once again the House International Relations Committee on Tuesday that all is well with the bailout and that the fundamentals of the Mexican economy are sound. What a devaluation of the word "fundamentals."

Deputy Secretary of State Peter Tarnoff extended this deluded presentation to the political realm. He recited the Administration's 1993 NAFTA talking points about Mexican political reforms and democratic gains, even as civil war in Chiapas and general political upheaval builds. He spoke of ever greater cooperation in the wars on illegal drugs and immigration, even as the *New York Times* reported this weekend on reduced drug interdiction because of NAFTA's phasing out of truck inspections and as the northward immigration waves inevitably swell in response to the devaluation of the peso and a collapsing economy. Tarnoff talked up environmental and labor cooperation, though both NAFTA side agreements have been declared useless by environmental and labor experts. The divorce between Administration officials and reality is so severe that it would be ripe for political satire were the implications not so dire.

7. *What Will the United States Do to Limit the Crisis' Damage to U.S. Jobs and the Economy?*

Meanwhile, the Mexican crisis can no longer be seen as a temporary one. A massively devalued peso is the new reality which Congress must face, even if Administration officials decline to face reality. It is now incumbent upon Congress to hastily formulate an emergency response to this new reality. While NAFTA boosters were using dubious formulas that attach 20,000 jobs to each $1 billion of gross exports to Mexico to claim NAFTA was benefiting U.S. workers, in fact, even before the devaluation over 30,000 U.S. workers had filed with the Department of Labor for special NAFTA unemployment and training assistance. Looking at gross imports is of course misleading. In fact, *before* the devaluation, the vaunted U.S. trade surplus with Mexico, which NAFTA boosters touted as proof of early U.S. NAFTA gains, reversed into a trade deficit. Now, even NAFTA promoters sheepishly acknowledge that NAFTA benefits for the U.S. economy are out of the question in this century.

Post devaluation, U.S. exports to Mexico have dried up. In fact, the December press reports of the devaluation suggest that a controlled devaluation was the strategy of the Mexican government to transform its trade deficit with the United States into a trade surplus. By devaluing the peso in an orderly fashion, the Mexican government hoped to gradually make U.S. goods prohibitively expensive—more than offsetting the advantages that U.S. businesses had gained through tariff reductions. At the same time, an orderly devaluation would make Mexican products and labor even cheaper and more competitive. As the Chairman is certainly aware, one of the largest of such devaluation-spurred job losses was the Mattel Big Wheels plant in upstate New York. This devaluation strategy should come as no surprise. It was accurately predicted by numerous NAFTA critics and was the subject of a House Small Business Committee hearing in the spring of 1993.

The Dallas Federal Reserve Bank, DRI McGraw Hill, and the March 1, 1994 *Wall Street Journal* have all forecast significant U.S. job losses as a result of the peso devaluation, which should speed the southward flow of jobs. What is the plan to stop this economic and job hemorrhaging before it is too late? Will it take tens of thousands of additional jobs or hundreds of thousands before Congress will act? Will Congress provide assistance to the new NAFTA victims or will this aid have to be foregone under the new austerity measures Congressman Leach alluded to? Why is there no equivalent of an ESF to rescue families in this country when their jobs head south, their mortgages go unpaid, and their children go without? Conducting foreign economic policy by the dictates of multinational corporations is fraught with risks to Main Street and Elm Street USA.

8. *Astonishingly, the Administration Is Still Talking About Expanding NAFTA*

Common sense and prudence would suggest that in light of the Mexico/NAFTA performance, the United States would indefinitely postpone any thought of expanding trade negotiations with other oligarchic nations in South America. Many Members of Congress assume that NAFTA expansion is on hold. "NAFTA expansion? You must be kidding," they have told me. Even pro-NAFTA columnists, such as the *Wall Street Journal's* Paul Gigot, are bashing the Administration for mishandling the peso situation and have pronounced NAFTA's reputation and it's planned expansion as casualties of the debacle.

Again, the Administration refuses to confront reality. Now that the bailout has been arranged through the Treasury Department's back door, the Clinton Administration is doing its best to distance the bailout and Mexico's problems from NAFTA. Having grown too accustomed to trumpeting NAFTA as one of its crowning foreign policy achievements, the Administration does not appear to have come to grips with the fact that economic integration with Mexico is now widely viewed as a liability both domestically and abroad. Incredibly, after the peso crash and back-door bailout, in a long February 9, 1994 speech about hemispheric trade at the Center for National Policy, USTR head Mickey Kantor, suggested that the Administration intended to speed up negotiations on NAFTA expansion. In his speech he said that negotiations to include Chile in NAFTA are to start in March. Kantor announced a ministerial-level meeting with the three NAFTA countries and Chile for May. He also announced a Summit of the Americas II meeting for June 30 in Denver to push for broader expansion of NAFTA to the rest of the Latin America. This is one stubborn Kantor in Wonderland.

Instead of hearing Congress' reasonable skepticism, the Administration appears to be testing whether Congress can be bypassed on NAFTA expansion, as it was on the bailout. It looks as if the Administration plans to begin negotiations with Chile and, once they are underway, come to Congress for fast-track authority for Chile. When it encounters the inevitable resistance, one can already foresee the Administration's all-too-familiar response: fast-track must be expanded or the United States will lose international stature and the markets will go haywire. The Administration has made a symphony of crying "Wolf!" too many times.

Unfortunately, U.S. power in the new World Trade Organization (WTO), which U.S. Trade Ambassador Mickey Kantor insisted would be potent—despite the clear one-nation-one-vote language in GATT to the contrary—already has been significantly devalued in the first critical decision of that new body: selecting its head. The Administration had sunk a heavy investment of its political capital into former President Salinas and now finds itself with a further loss of influence as other nations choose the first chief of the WTO. Clearly, the United States should not expand NAFTA because NAFTA is a bad model. A fundamental lesson of this crisis is that economic freedom and integration cannot be divorced from political freedom and democracy. The starting point of the search for a new model of trade and investment should be a simple premise: there should be no talk of such comprehensive economic treaties with a country unless its people are free to choose their own government, its unions are free to bargain for a just wage, and the rule of law with due process has been established.

9. *A Pattern of U.S. Anti-Democratic Activity that Must be Stopped*

Another casualty is our own democracy, which is weakened not only by the secretive, dishonest selling of the NAFTA and GATT, but by the sort of activities that are necessary to shore up these flawed economic models, such as the end-run around Congress on this bailout and secretive plans to expand the NAFTA affair. While the tradition of fast-track stampeding and demeaning of the congressional function where trade agreements are concerned appears likely to continue unabated, there is something new in the U.S. Government bailing out private investor debt offshore. This is clearly a new twist in the relentless growth of corporate socialism, whereby the American taxpayer is forced to socialize Wall Street's losses while those banks, investment banks and mutual funds privatize their profits. While the democratic cost of railroaded trade agendas is difficult to quantify, the meter is clearly running on this newer threat to the fabric of U.S. democratic society.

There are prices to be paid for congressional indifference to the absence of any administrative due process in the making of the Government's corporate welfare policies paid for in ever more arcane ways by the taxpayers. One price is that private privilege becomes public policy through secret government that is unaccountable and is afflicted by the institutional conflicts of interest perpetrated by Government officials on leave from their financial posts in New York. Another price is the increasing politicization of the Federal Reserve by its leaders, whose vigorous involvement with the Administration to gain congressional support for the bailout has dismayed at least one of Mr. Greenspan's predecessors. But the largest price will be paid by the spreading revulsion among the American people to the imperious demand that wealthy people and institutions who *do not* play by the rules get bailed out by working people *who do*. If there are any Members of Congress who have the slightest doubt that this deep sense of unfairness is widespread and mounting, they should turn on the more evenhanded talk radio shows or directly sample opinions back home.

Congress must draw a line at this Executive Branch usurpation of power and the Executive's negligent giveaway of political control to unaccountable corporations and

private financial institutions that dominate this "new global economic system" that is often alluded to but rarely described in any detail. Congress is implicated in this abdication by approving the autocratic regimes of NAFTA and GATT and for not stopping this bailout.

10. *The Bailout's Many Critics*

The staggering $50 billion back-door bailout announced by the Clinton Administration on January 31, 1995, once it became clear that congressional approval of any bailout plan was unlikely, has three main components. The ESF commitment is $20 billion in currency swaps, loan guarantees, and loans. Both the amounts and the maturities involved (up to 10 years) are far and beyond anything that the ESF has previously supported. The International Monetary Fund is offering a package worth $17.8 billion. Finally, the Bank for International Settlements will provide $10 billion in assistance and Canada and several Latin American countries are offering an additional $2 billion. Both this bailout plan and the previously proposed one have attracted a broad range of critics.

First of all, William Seidman, former Chairman of the FDIC, is one of several establishment figures who scoffed at the scenario of Mexican collapse unless there is an emergency cash transfusion. He opposed the Mexican bailout. He said before the unilateral White House decision to bail out the Mexican government, that if the pro-bailout advocates are right about there being no real economic problem in the long term, there should be no panic. Too much short-term borrowing by Mexico has led to losses and the debtors and creditors should sit down and negotiate a settlement, he urged, concluding with these words: "Congress is right to hesitate. Although reversing course at this point will be difficult and the screams of disaster will be deafening, the course being set in haste can only lead to larger U.S. financial obligations and a reduction of market discipline. That's just the way we don't want to go."

The key word is "discipline." What progressive standards of discipline were attached to these loans, if only to reduce the likelihood of worse situations occurring in the near future? None. Notice the slide into a spiral of bailout aggressiveness since the early 1980's. It used to be that bailouts of banks whose loans and speculations soured were justified as protecting depositors; now bailouts are directed to protecting investors who gambled and lost. Moreover, the scale is much larger as the abyss of undisciplined official and private greed in Mexico and Wall Street becomes deeper and obligates the U.S. taxpayer. Has Mexico now joined the list of big banks deemed *too big to fail*? What are the portents of such a burden on American labor from the devalued peso's sizable lowering of comparative wages of Mexican labor?

Second, unless Congress acts, a terrible precedent for U.S. taxpayer guarantees of emerging markets in other South American countries will have been set on behalf of institutional investors. One "special circumstance" loan guarantee or bailout can always be used to justify another and with the same appalling lack of administrative and legislative due process.

Third, this proposed loan guarantee cannot deal with the deep structural problems of the Mexican economy as if the Mexican people mattered—problems that are the result of a dictatorial oligarchy, that knows few self-restraints, and a binge of credit expansion that is coming due for domestic banks and businesses.

Therefore, if this bailout is stopped by Congress (where are the countries of Western Europe and Japan who have trade surpluses with Mexico, by the way?) are there any alternatives? Yes, the U.S. Government should perform a referee function to get the debtors and creditors to settle up and to commit the Mexican mega-billionaires to provide guarantees for their own government from whose policies they made so much of their unearned fortunes. After all, institutional investors and these oligarchs made a great deal of money from Mexico's "emerging market" in recent years. It is time for these wealthy oligarchs and institutions to return some of these gains by way of a settlement. This would provide a measure of responsibility for the players in this arena, send a signal to future speculators who harbor the "too big to fail" expectation that Uncle Sam (or is he Uncle Sucker?) will take their losses while they preserve their profits.

To put it symbolically, if Wall Street expects to be able to stampede Washington any time the Street's risks materialize in a foreign country, those risks will be taken every few years again and again and on an ever-larger scale. Insiders who counsel prudence will be waved aside in the rush to speculative excess and the Washington corporate welfare system will continue to mushroom. Congress is big on demanding that welfare for the poor require work fare, discipline, training, and 2-year limitations. Is Congress now about to burden middle class taxpayers with a big new welfare ward in the form of a Mexican regime that exploits its people, suppresses their rights as workers, consumers, and citizens, and favors a tiny group of immensely wealthy oligarchs, with its privilege and police powers, who dominate the economy?

Consider the inequity to both the Mexican and American people of applying the "full faith and credit" of the U.S. Government to this transborder frenzy of speculative investing and reckless borrowing instead of more deliberate and intelligent policies that would foresee and forestall a crumbling future. Those policies should be considered by several congressional committees as soon as possible also under the rubric "economics as if people mattered."

PREPARED STATEMENT OF JOHN MUELLER

VICE PRESIDENT AND CHIEF ECONOMIST, LEHRMAN BELL MUELLER CANNON, INC., ARLINGTON, VA

MARCH 9, 1995

Why the Peso Bailout Weakens the Dollar

Thank you, Mr. Chairman. I appreciate your invitation to talk to the Senate Banking Committee about the crisis in Mexico. With your permission, I would like to submit for the record two recent papers by our firm concerning the effects of the bailout on Mexico. The papers examine the crisis, largely from Mexico's point of view, and explain why Mexico is unlikely to meet the economic targets outlined in its agreements with the IMF and the U.S. Treasury. For example, the inflation rate is likely to be two or even three times the official forecast of 19 percent in 1995. This has serious implications for the future stability of the peso.

In my statement this morning, though, I'd like to consider the impact of the Mexican crisis on our own currency, the U.S. dollar. As you know, since the Mexican crisis began last December, the peso has dropped about 50 percent, from 3.5 to about 7 pesos per dollar. The accompanying chart shows that the weakness of the peso against the dollar has been mirrored—almost on a daily basis—by weakness of the dollar against other major currencies like the Deutschemark. Before Christmas, the dollar was worth 1.58 Deutschemarks. Yesterday it fell below 1.35 Deutschemarks—a drop of 15 percent—before recovering.

It would be a mistake to oversimplify this relationship which, after all, involves the whole economies and financial markets of our two countries and, in fact, of the rest of the world. But the Mexican crisis is almost certainly the biggest single factor in explaining the dollar's recent decline. In particular, the bailout itself forces an easier U.S. monetary policy than would otherwise occur. I would like to explain why this is so.

The U.S. monetary authorities are, in effect, loaning dollars to the Mexican monetary authorities. We give dollar IOU's and receive peso IOU's in return. Until Mexico repays these loans, which will take 5 to 10 years, this amounts, in effect, to issuing new dollars backed by pesos.

The process can expand our own money supply in one of two ways—depending on whether it is financed through the Federal Reserve or the Treasury's Exchange Stabilization Fund (ESF), which share our Nation's $40 billion official reserve of foreign currencies.

Under the Monetary Control Act of 1980, the Federal Reserve may purchase peso assets in just about any amount it pleases. But when this happens, it equally expands Federal Reserve liabilities—which constitute the currency and bank reserves, or so-called "high-powered money," of the United States. As of last week, the Federal Reserve's foreign currency holdings had increased about $3 billion since early December. There is some evidence that the Federal Reserve at first provided more than this, but then transferred the ownership to the Treasury.

In theory, this expansion of money could be offset by the Federal Reserve selling an equal amount of U.S. Treasury securities. However, since mid-December, the U.S. monetary base—that's another name for our high-powered money—has expanded by more than $8 billion, even taking seasonal variations and reserve requirements into account.

This brings us to the other process by which the bailout affects U.S. monetary policy. Back in December, the Treasury held, in its Exchange Stabilization Fund, about $20 billion worth of foreign currencies, mostly yen and Deutschemarks. According to Administration officials, the Mexican bailout was not supposed to be financed by reducing the amount of yen and Deutschemarks. In that case, how can the loans to Mexico be financed? Essentially, the Treasury must borrow by issuing U.S. Treasury bills, and then deliver the proceeds to Mexico, receiving peso IOU's in return.

This extra U.S. Treasury borrowing would ordinarily tend to drive up short-term interest rates in this country, but with the Federal Reserve targeting the Federal

Funds rate (currently at 6 percent), and with the Treasury bill rate almost exactly at the Federal Funds rate, what happens instead is that all the extra Treasury debt is purchased by the Federal Reserve—expanding the supply of currency and commercial bank reserves. This excess money quickly finds its way to the foreign exchange markets, increasing the supply of dollars offered against Deutschemarks and yen. This is what depresses the dollar against other major currencies.

The point, then, is that whether or not the bailout is financed directly by the Federal Reserve, it can force an effective easing of U.S. monetary policy—unless the Federal Reserve deliberately raises interest rates in step with the additional demand for credit. But the Federal Reserve has not chosen to do so.

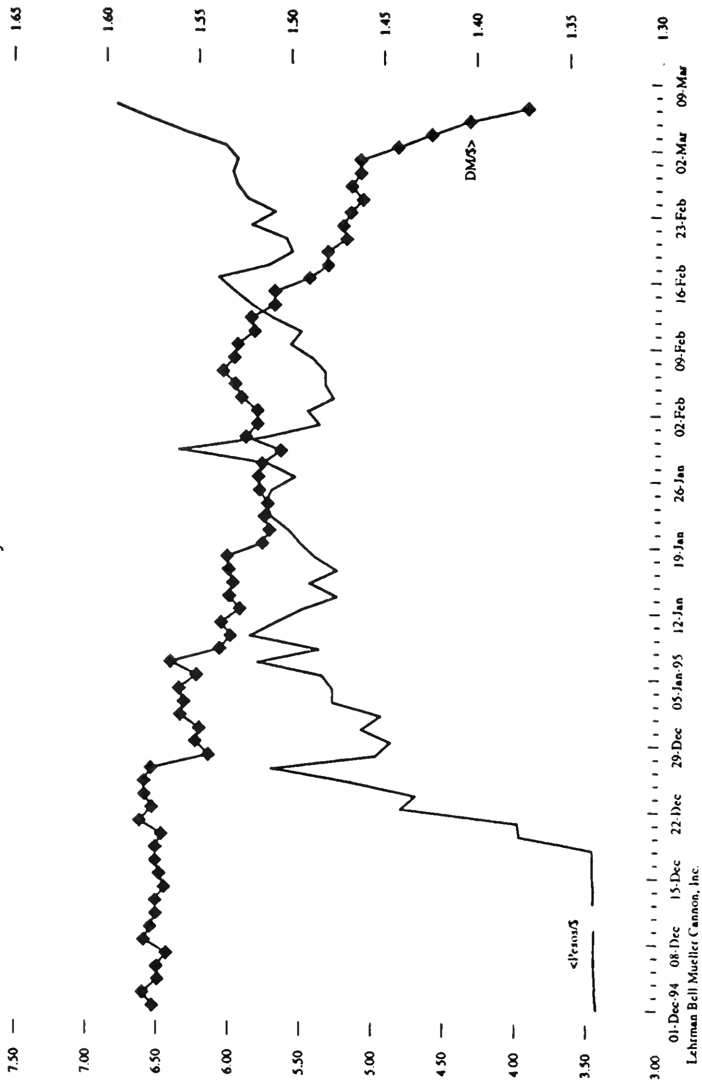
I'm not qualified to say whether using the Exchange Stabilization Fund to support the peso is legal, but it is quite clear that this represents a significant change in policy by the Federal Reserve and the Treasury. The most recent official report on Treasury and Federal Reserve Foreign Exchange Operations noted (as it usually does) that, "The U.S. monetary authorities regularly invest their foreign currency balances in a variety of instruments that yield market-related rates of return and have a high degree of liquidity and credit quality" (Federal Reserve Bulletin, December 1994, p. 1076). It certainly cannot be said that the loans to Mexico have a high degree of liquidity; moreover, the current crisis was triggered largely by the fact that the Mexican government was about to default on its debts.

There are some fundamental reasons which suggest that the dollar ought to be bottoming against the other major currencies and beginning to strengthen; but right now, it's clear that the major cause of the recent dollar weakness is the situation in Mexico, and especially the bailout of the peso.

Thank you, Mr. Chairman. I'll be happy to answer your questions.

Dollar vs. Peso & Deutschemark

Daily close



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Emerging Markets Watch

February 3, 1995

Mexico: The economic consequences of the bailout

Of Importance to Investors: Politically, President Clinton's peso stabilization plan was pure San Francisco 49ers. He acts decisively. It gets Republicans off the hook and off his back. It buys critical time for Mexico to restructure its banking system and mitigate the drubbing of many U.S. investors.

But an LBMC economic analysis shows the plan is more like the San Diego Chargers in substance. It will likely cause an increase in Mexican inflation. This should top 40 percent annualized by late 1995 (not the 9 percent foreseen by the IMF for December). This will work against improvement in Mexico's current account deficit, itself a major cause of the devaluation. And it ameliorates, but won't eliminate, the crisis for banks and other Mexican dollar debtors.

The *strongest* exchange rate Mexico's likely to achieve will be five pesos to the dollar. Six to one is more likely, and that *only if the Banco de Mexico moves quickly and the bailout plan is limited.* (In the first plan's *four days*, the U.S. Fed has spent more than $4 billion of a planned $5.5 billion, 25 billion pesos, equal to Mexico's net domestic asset growth over *six months*.)

Bottom line: Still out, watching for "insider buying," i.e. the return of flight capital. Short the vulnerable banks and dollar debtors. The only buy possibilities: exporters (such as steel, auto parts, and machinery) and large peso debtors.

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BILL CLINTON grabbed the reins Tuesday and rode to rescue of the peso with presidential *elan*. Markets were reassured that someone, somewhere, is doing something. The executive directors of the International Monetary Fund added their own seal of approval to an $18 billion credit late Wednesday, bringing total support to more than $50 billion. By Thursday the Federal Reserve had already spent $4.5 billion of its pledged $5.5 billion, buying some 25 billion pesos with dollars.

Now what?

After a bounce off the bottom for the bolsa, investors and politicians are left to ponder the consequences of the monetary peace.

A trillion dollar analogy

The assistance program of $50 billion is about one-fifth of Mexico's Gross Domestic Product. Or, $500 for every Mexican, in a country with per capita income of about $2500. That's about $1 trillion as a comparable share of the U.S. economy — roughly the size of the federal government.

Thus, the peso package is comparable to someone offering in 1979 to buy $500 billion worth of dollars. At first glance, this would seem to "mop up" billions, bringing the double-digit inflation of the 1970s under control.

In fact, this was roughly what foreign central banks were doing from 1978 to 1980, even as the dollar fell to new lows and prices soared. They purchased dollars all right — with reserves that had the same effect as expanding the U.S. monetary base. The dollars, meanwhile, were turned into interest-bearing instruments on deposit at the New York Fed, where they were part of the monetary base of the countries who bought them. Nothing was subtracted or "mopped up" from the system; rather, titles were swapped, the locus of dollar creation somewhat altered. Dollar-denominated debt rose, but without becoming a liability for the central banks: What French economist Jacques Rueff called a "childish game." The monetary adjustment mechanism was jammed.

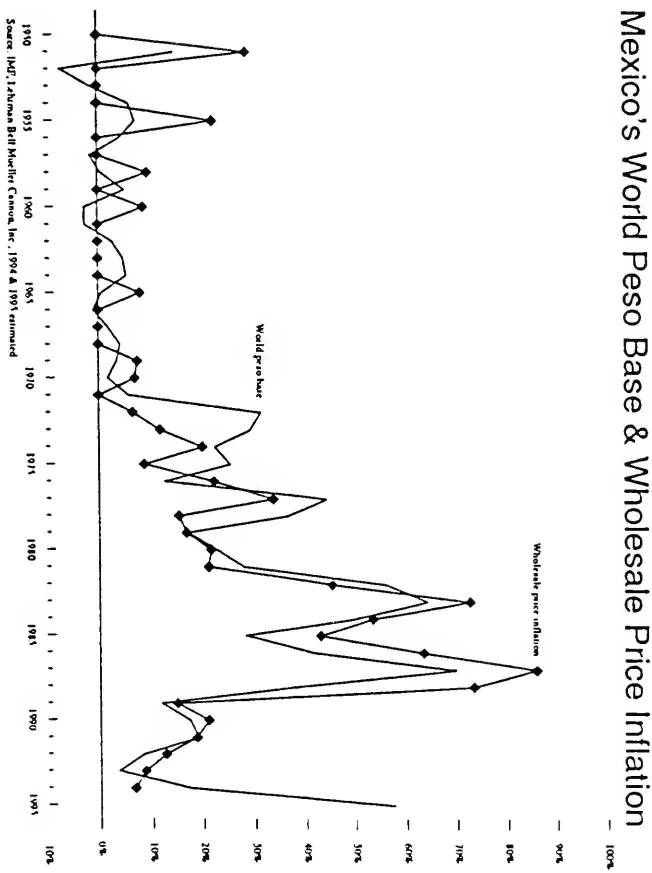
Pesos as reserves

What does all this have to do with the Mexican peso? Potentially a lot.

Under the joint Treasury Department/ Federal Reserve/ International Monetary Fund assistance effort, *perhapse one-third to one-half of the peso assets swapped by Banco De Mexico and the other central and multilateral banks will be monetized* — placed on someone's balance sheet without an automatic corresponding extinguishing of credit somewhere else in the system. If other central banks stored the pesos, reducing the Mexican monetary base, then things would cancel out.

Mexico's banking system, though, on the brink of collapse. If there were no need to liquify this system, it might not have abandoned discipline so fast in the year prior to the devaluation.

THE IMPACT on the world's supply of Mexican pesos as reserve assets is shown on the table on the next page.



Lehman Bell Mueller Cannon

As the chart shows, there is a strong correlation between the base of peso reserves at the central banks and the Mexican wholesale price index going back almost 50 years.

"Just the Fed's action this week, purchase of some 25 billion pesos," observes LBMC chief economist and vice president John Mueller, "constitutes a significant expansion of the peso base."

How much inflation this produces how fast depends on several factors.

PRICE CONTROLS are one factor. It's not clear whether the government will be soft about the Pacto, and allow inflationary pressures to become explicit, or really crack some heads against "speculators," and have gas lines and shortages. Either way the *de facto* inflation will show up in the system though: one way, in direct cash prices, the other in implicit costs of time and product availability.

ANOTHER FACTOR is domestic monetary policy. Mexico's performance here is one of the main elements of IMF conditionality: The government has pledged approximately 17 percent annualized growth in net domestic credit.

By conventional domestic monetarism, this too would seem to be consistent with 19 percent inflation, another target in Wednesday night's IMF deal. To read Mexico's central banker, in fact, one would think it almost guarantees it. (Miguel Mancera, "Don't Blame Monetary Policy," *The Wall Street Journal*, January 31, 1995.)

But if Mancera is right, his model fails to explain the crash of the peso on December 20, on the mere news of a slight adjustment in the band. Was the peso crash just a huge misunderstanding?

The table on peso reserves suggests not. And one problem with merely domestic monetary tightening, accompanied by massive peso reserve creation overseas, is that it is likely to confuse the Banco de Mexico, the IMF, and the U.S. Treasury into thinking policy is "tight," just as Mancera thought it was in 1994, when it is aggressively expansive.

A THIRD FACTOR is the Mexican banking system, the vulnerability of which is a driving factor behind loose monetary policy. The dollar debts of many banks, and now-devalued peso assets, make it unlikely that the Banco de Mexico will stuff its dollars into a mattress.

Chris Whalen, a maverick but sharp expert on the Mexican banking stystem, estimates the bad debts in the system may be as high as $200 billion. (Like LBMC, Whelan predicted a significant peso devaluation.) Even if the rot is only half that large, and even if the $50 billion in bailout resources could be mobilized, much carnage remains for the banks themselves and many of their largest corporate clients. Bad news for the financial sector.

3.5 strikes and you're out

A MAJOR CONCERN for many Mexican (and U.S.) banks and investment houses is, what will all this mean for the

exchange rate?

There is no Fund-conditional rate in Mexico's revised agreement with the Fund approved Wednesday night, nor is one likely to emerge in talks between Finance Minister Ortiz and the Treasury. Not even a target date for leaving the current *de facto* float is stated. This is not unexpected, nor is it bad. "Repegging the peso," as Mueller notes, "must wait until the bailout is finished and Mexico's monetary policy is changed to stop big swings in domestic credit expansion."

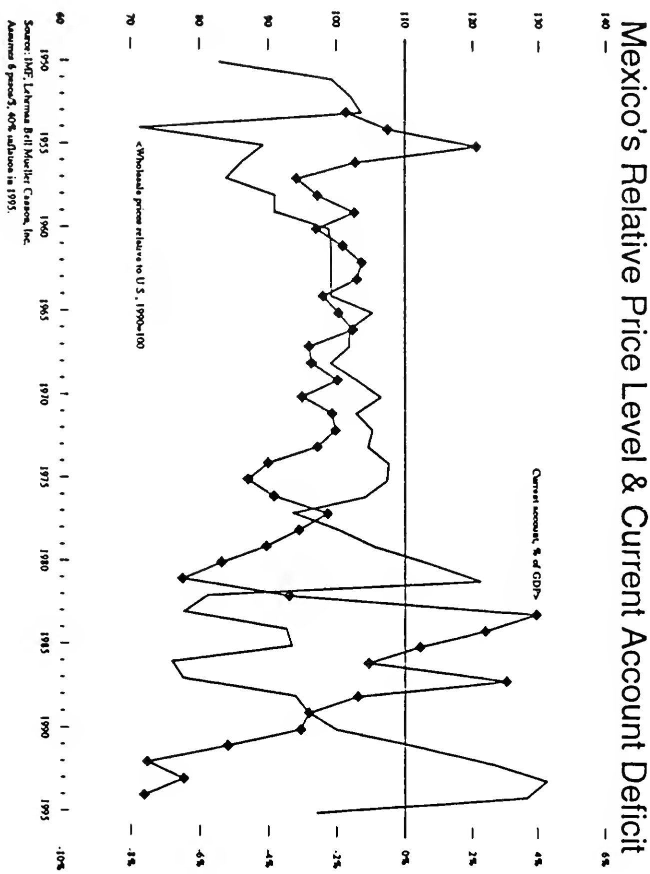
Regarding timing, as the Fed's buying and the IMF's special session suggest, U.S. and Fund monetary authorities think the key is for them to act quickly and decisively, "scalding the speculators." If we're right about the monetization effects, this will have the perverse impact of driving up Mexican inflation. The Fund expects a quick spike in prices in the next few months, as the devaluation is discounted — but with inflation dropping into the high single digits by December. In fact, with caveats for the effect controls may have on apparent prices, it's much more likely there will be rising inflation come December. Perhaps 40 percent.

IMF OFFICIALS believe that with the package, the peso will move "towards" its old rate of 3.5 to the dollar, though no serious official at the Fund or the U.S. Fed or Treasury seems to be advocating a return to 3.5-to-1 exchange. (Alan Greenspan mentioned the target as one Mexico expects to "move toward" at a dinner with other Fed governors recently, but "it was as a joke," according to one of the diners. "We roared.") This raises the question of what will happen if, as we anticipate, the package has an inflationary impact unexpected by the Fund and the Banco de Mexico.

On the upside, there are some practical limits having to do with the bailout operation itself, and with Mexico's current account balance.

THOSE LIMITS are suggested by the chart on the next page, compiled by John Mueller. It tracks the relationship between Mexico's price level (relative to the U.S. price level), on the one hand, and its current account deficit (expressed as a percentage of GDP), on the other.

To restore its current account deficit to a sustainable level, the Mexican price level must return to its long-run average relative to the United States. Even if Mexico hits the 19 percent inflation target for 1995, the peso would have to be at least at least five to the dollar to do this. The table assumes a 6-to-1 exchange rate and a 40 percent inflation, which is roughly the same because the 20 percent further depreciation of the exchange rate offsets the 20 percentage point increase in inflation.


Mexico's Relative Price Level & Current Account Deficit
<Wholesale prices relative to U.S., 1990=100
Current account, % of GDP>
Source: IMF, Lehrman Bell Mueller Cannon, Inc.
Assumes 6 pesos/$, 40% inflation in 1995.

EVEN THESE conditions are not likely to produce the IMF's 3-4 percent target for current account deficit in 1995-96. Given the inflationary tendencies of the bailout plan, Mexico's relative price level is liable to remain high, with the reflective and corresponding current account deficit larger. Which will bring back some of the very forces for devaluation that led to the plan.

AN ANALOGY to the Bretton Woods breakup helps to clarify.

When President Richard Nixon de-linked the dollar from gold in 1971, and began to devalue the dollar against the Japanese yen, wonderful trade consequences were predicted. "The drift to disaster is ended," *Forbes* magazine editorialized (September 1, 1971). "No longer can Japanese industries count upon flooding the market with an increasing folume of their exports," Paul Samuelson wrote in *The New York Times* (August 18, 1971.)

In fact, of course, the floating dollar never brought about a trade balance with Japan. Not when the dollar sagged as low as 200 yen later in the decade. Not when the Plaza accord drove the dollar down; not when the greenback broke the 100 barrier in the 1990s.

There are vast differences between Mexico's situation today and the U.S. position in 1971. There are, however, important monetary similarities — similarities that will grow as the IMF, Federal Reserve, and Treasury treat the peso as a *de facto* reserve asset.

Investment strategy: Mexico

1. Still out the general Mexican equities market. Overnight interbank rates in the high 40s, more than double their pre-devaluation rate, give no evidence of Mexican confidence in the Mexican monetary regime.

2. Short the banks, importers, manufacturers with high import components and high domestic consumption rates, and companies with high dollar debt.

3. Buy — if at all — only major peso debtors and competitive exporters such as steel and auto parts, and these only if their net liabilities are not "long" the dollar.

THE MORAL to this story seems to be that you can fool most of the investors some of the time — but then you're in trouble. Mexico learned this in late 1994. The Treasury-Fed-IMF bailout team, unfortunately, may have to learn the hard way. And it will be costly, for us and Mexico. ■

In our next report: Aftershocks for the Latin "EMS" — investment strategy for Argentina, Bolivia, Brazil, Peru, Venezuela, and Chile. ■

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Emerging Markets Special Report

February 16, 1995

The Continuing Crisis in Mexico

by John Mueller

Conclusions of importance to investors:

■ Inflation in Mexico is likely to be considerably worse than official estimates of 19% -- probably around 40% in 1995, though likely lower in 1996.

■ Mexico's current account balance should improve sharply at first (though because of reporting delays this may not be known for another year) but then move sharply back into deficit.

■ The current exchange rate of about 5.5-6 pesos per dollar is sustainable for much of 1995 (apart from new political shocks), but the rate is likely to fall to at least 7 in 1996.

■ Mexican stocks are largely driven by the same liquidity cycle as American stocks -- which turned negative last fall. This is why the Mexican market defied predictions of a decline through 1994, despite substantial overevaluation of the peso. Down 40% in dollars since LBMC's devaluation call, Mexican stocks may have seen the worst; but liquidity will not turn positive again until 1996.

A Surplus of Explanations

Basically three kinds of explanations have been put forward for the collapse of the Mexican peso and associated carnage in Mexican and other emerging markets.

The official Mexican version blames political events -- the revolt in Chiapas, an assassination, accusations of political corruption -- for a loss of investor confidence and a run on the Bank of Mexico's foreign exchange. Others point to expansion of credit via official development banks, which belied a supposedly tight fiscal policy.

A second family of explanations focuses on Bank of Mexico policy. One variant argues that the central bank could have avoided devaluation by

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putting up interest rates sooner in 1994, rather than expanding domestic credit to replace lost reserves. Another variation doubts that this would have worked because the Mexican currency became overvalued by certain measures for years before the crisis occurred (though this does not explain why the crisis tarried). Such analyses are sometimes coupled with the advocacy of a "currency board" arrangement for Mexico -- a fixed-exchange rate arrangement which would back peso currency and commercial bank reserves entirely with foreign currency. Still another version argues that the devaluation was unnecessary but more or less deliberately chosen in the (misguided) hope of reducing the current account deficit, which had reached 8% of GDP.

A third explanation focuses on international pressures created by the tightening of policy by the Federal Reserve, which attracted money back to the U.S. and out of emerging markets.

Not all of these explanations are mutually exclusive. In themselves, all seem plausible -- but are they true? The only way to make a sound judgment is to understand the basic logic of the Mexican economy.

How to Think About Mexico

Perhaps the best way to think about Mexico is to consider it a poor region of the American economy which happens to have a different currency -- as it were, turn-of-the-century Mississippi with a peso. The Mexican economy has long been closely integrated into the U.S. economy, well before NAFTA. We can see this by comparing the peso exchange rate with the ratio of Mexican to U.S. wholesale prices over the past half-century (Graph 1). The price level in pesos is clearly dominated by exchange rate changes. The relationship approximates the "law of one price" -- the idea that, because of arbitrage, prices are the same in both countries, except for the costs of transport and tariffs.

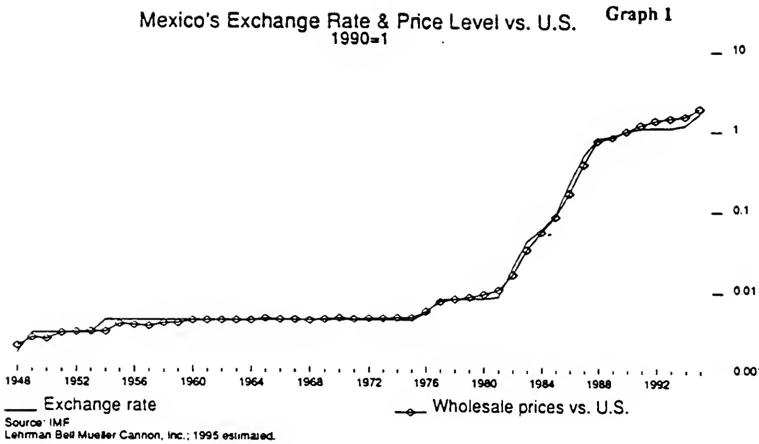
A closer look, using monthly rather than annual data, reveals that this adjustment is not instantaneous, however (Graph 2). Eyeballing the relationship suggests that adjustment between prices and exchange rates begins immediately but takes about two years to accomplish. This finding is confirmed by statistical tests. If we allow for the speed of adjustment, we find that it is possible to predict Mexican wholesale price inflation based solely on the U.S. price level and the peso exchange rate, using either annual or monthly data (Graphs 3 & 4). Because the Mexican consumer price index behaves almost the same as wholesale prices, we can use this forecast for either purpose (Graph 5).

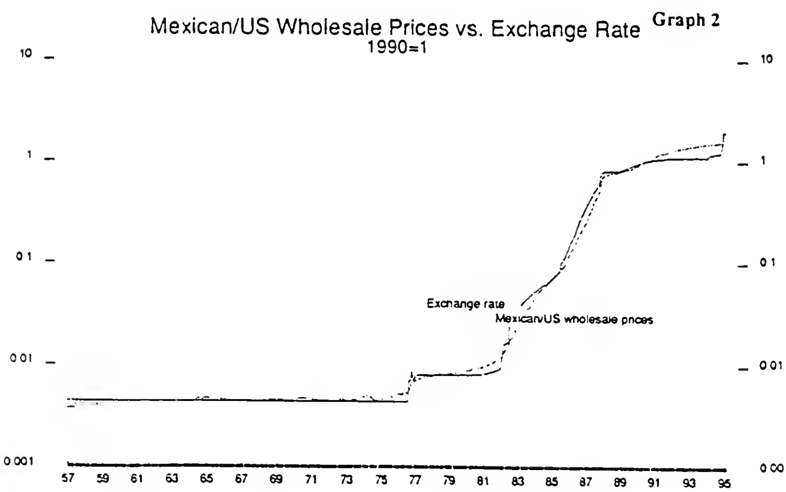
Note that the prediction of LBMC's model suggests an inflation rate of about 40% in 1995. This is considerably at variance with the official forecast of the Mexican government and the International Monetary Fund, which sees inflation of 19% in 1995, and falling to single digits by year-end. Before considering the reasons for this disagreement, let's take a closer look at the adjustment process.

Devaluation vs. Deflation

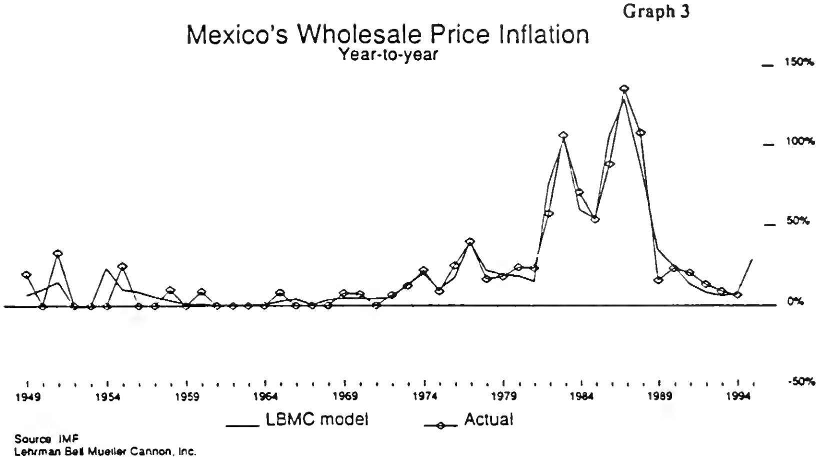
As we have seen, the Mexican price level can differ from parity with U.S. prices measured in the same currency (Graph 6). This difference has two components: a temporary variation which is due to the lag in adjustment between the price level and the exchange rate; and an upward trend of Mexican prices (a bit less than 1% a year) which is probably related to the fact that Mexican per capita wealth is catching up over time to the American living standard -- though still far below it in absolute terms.

This variation in Mexico's relative price level, in turn, is associated with swings in Mexico's current account -- its trade in goods and services with the rest of the world (Graph 7). A fall in relative prices quickly leads to a smaller deficit or a larger surplus, while a rise in relative prices is quickly followed by

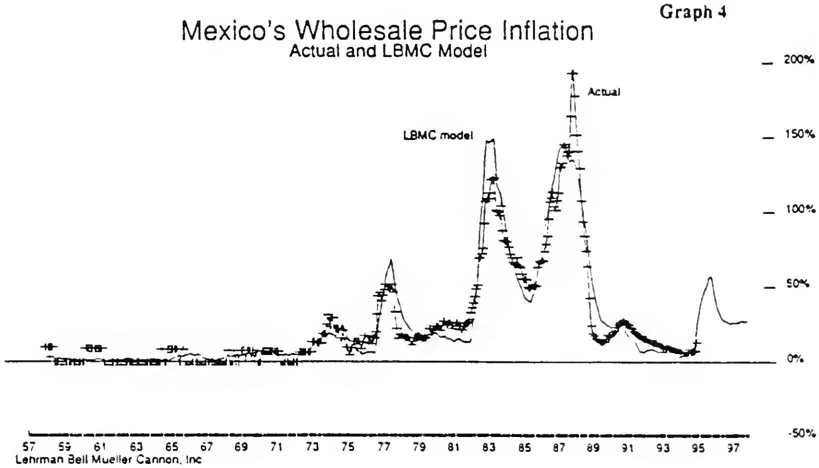

Mexico's Exchange Rate & Price Level vs. U.S.
1990=1
Graph 1
10
1
0.1
0.01
0.001
1948
1952
1956
1960
1964
1968
1972
1976
1980
1984
1988
1992
Exchange rate
Wholesale prices vs. U.S.
Source: IMF
Lehman Bell Mueller Cannon, Inc.; 1995 estimated.


Mexican/US Wholesale Prices vs. Exchange Rate
1990=1
Graph 2
10
1
0.1
0.01
0.001
Exchange rate
Mexican/US wholesale prices
57
59
61
63
65
67
69
71
73
75
77
79
81
83
85
87
89
91
93
95

Graph 3



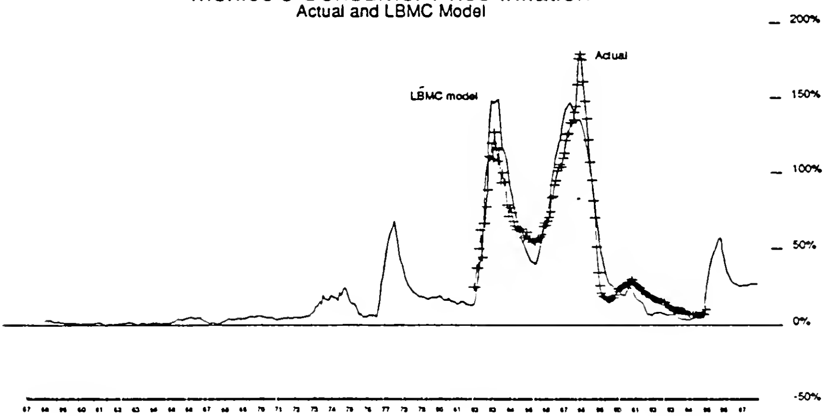
Graph 4



Graph 5

Mexico's Consumer Price Inflation

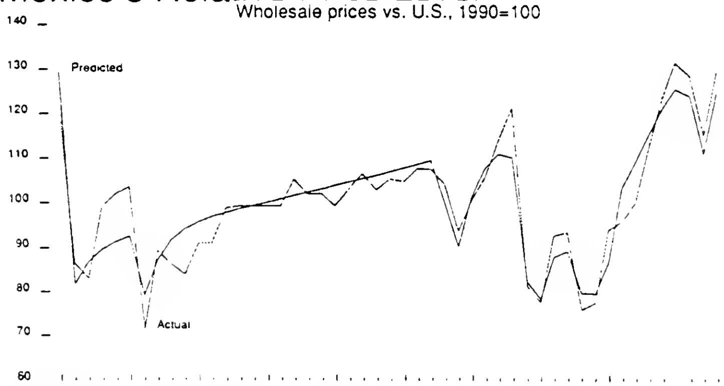
Actual and LBMC Model



Graph 6

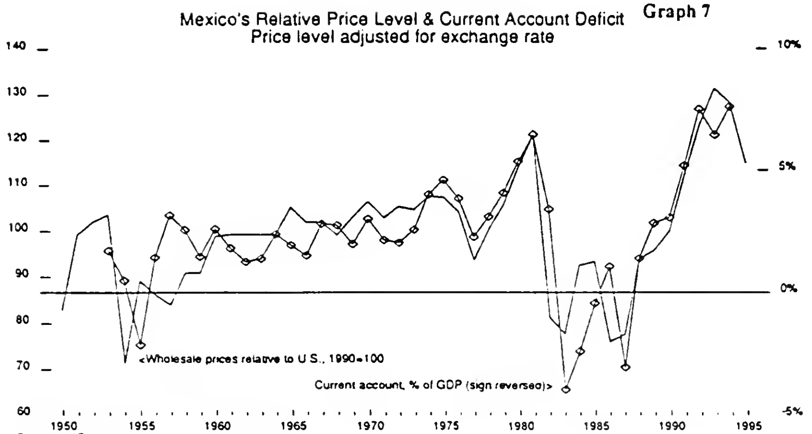
Mexico's Relative Price Level

Wholesale prices vs. U.S., 1990=100



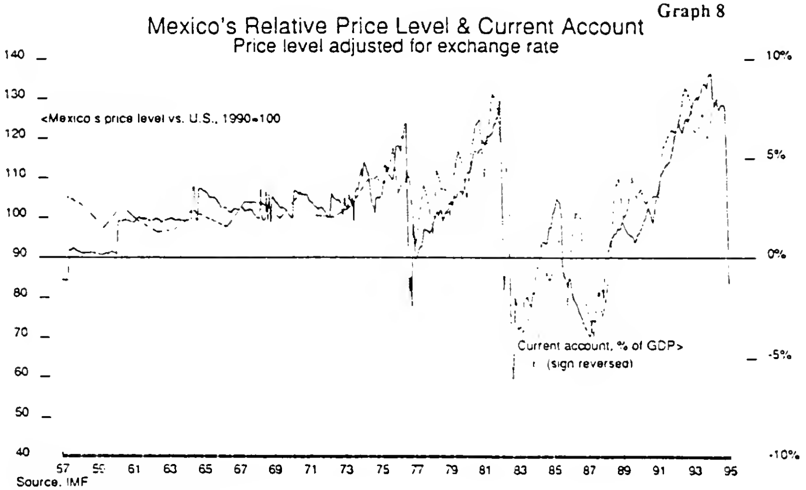
Source: IMF
Lehrman Bell Mueller Cannon, Inc., 1995 estimated

Graph 7



Source: IMF
Lehrman Bell Mueller Cannon, Inc.; 1995 estimated

Graph 8



Source: IMF
Lehrman Bell Mueller Cannon, Inc.

a larger deficit or smaller surplus. Anyone who doubts the sensitivity of the price mechanism would do well to ponder this relationship, which generally takes 3 to 6 months (Graph 8).

Despite the fact that higher Mexican prices raise the relative price level, declines in Mexico's relative price level are almost always associated with faster inflation. This is because the relative decline is usually brought about by depreciation of the peso, which outstrips for awhile the catch-up in the price level. Prices are rising, but not as fast as the currency is falling. The same result could be achieved with a fixed exchange rate and a deflation of Mexico's prices relative to the U.S. In fact, since the same relative adjustment must be made in either case, there would be no advantage to flexible exchange rates if prices and wages were perfectly flexible.

But, as we have seen, the price level is somewhat sluggish relative to exchange rates. And a glance at the relative magnitudes involved suggests why the Mexican monetary authorities have preferred devaluation to a fixed exchange rate. The Mexican price level, adjusted for exchange rates, has swung as much as one-third above or below the average U.S. price level in the process of adjustment. To achieve this adjustment under a fixed exchange rate would require the price level to double from its lows, and deflate by half from its highs.

It could be argued that part of this volatility is the result of lurches in Mexican monetary policy; but, as we will see, the pressures on Mexico and other emerging markets are in fact to a large extent beyond Mexico's control.

Mere inertia in the price level would make such a large adjustment a painful process in terms of unemployment, even though temporary. And there are institutional reasons -- such as the minimum wage -- which suggest that Mexican wages and prices would be more inflexible downward than upward. Thus pressures for devaluation rather than deflation will remain strong -- at least until Mexico becomes a more diversified economy, in which case the swings in the relative price level and current account would presumably be smaller. (For a complete discussion of when it is expedient, unnecessary, or useless to devalue a currency, see "Why Devalue?", LBMC Report, June 29, 1993)

Current Account Behavior

What does this have to do with the current account balance? A current account deficit is, by definition, equal to the excess of domestic investment over domestic saving -- the difference being the amount of capital supplied by foreigners for domestic investment. This can be looked at in two ways -- from the domestic and the foreign point of view.

A peso devaluation can temporarily increase the current account balance, but it should be emphasized that this is not brought about by changes in the exchange rate itself. A devaluation leads to a temporary increase in the current account, not because imports become more expensive and exports less expensive, but rather because the devaluation reduces the real wealth of Mexicans, mostly in the form of financial assets, below the amount they wish to hold. This causes Mexicans to consume and invest less, and save more, to rebuild these financial assets. This shift in saving relative to investment is what improves the current account. But once the actual stock of financial assets equals the desired stock, the swing in the current account is reversed.

Looked at externally, a current account deficit is the counterpart of an inflow of capital, for example, when investment in Mexico appears more attractive than investment in the U.S. These inflows are more often than not associated with swings in financial liquidity in the United States, as measured for example by LBMC's Liquidity Index, which we use as a timing device for stock market investment in the U.S. (Graph 9). When the U.S. banking system creates money faster than money is

absorbed in the real economy by increased prices or output, the surplus bids up the price of domestic financial assets -- bonds and stocks.

But the liquidity index works equally well for the Mexican stock market in dollars (Graph 10). As the price of U.S. financial assets rises, the yield declines, and so part of the surplus liquidity flows abroad as capital in search of a higher return -- raising foreign currencies and financial markets. Conversely, when liquidity begins to tighten in the U.S., capital outflows slow down or reverse. Thus stock markets around the world -- but especially in dollar-oriented emerging markets like Mexico -- tend to rise and fall at the same time.

Just as the capital inflows to Mexico are associated with a rise in Mexico's relative price level and a larger current account deficit, capital outflows are associated with a decline in Mexico's relative price level and a smaller current account deficit. Generally speaking, a 5% change in relative prices is associated with a 1 percentage point change in the current account.

Inconsistency of IMF Conditions

This brings us back to the (in)consistency of the IMF economic performance targets. Part of the inconsistency is due to the fact that the Mexican government is officially forecasting a peso rate of 4.5, while the peso rate at the time of this writing is about 5.65 per dollar.

If the peso rate stays at 5.5-6 for the time being, two things will happen. First, the current account is likely to increase dramatically -- with the deficit dropping from 8% of GDP to about zero, on a quarterly basis. (Because of reporting delays, this may not be known for another year.) Second, the Mexican price level is likely to rise at a rate of about 40% in 1995, not the 19% forecast by the IMF. But if the peso rate remained unchanged, Mexico's relative price level would rise back 40% in a year, too. That, in turn, would quickly reverse the whole change in the current account. It's possible that investors would not have the confidence in Mexican policies to invest at such a rate -- though for a time, the $50 billion international bailout package could supply the gap (if not fully offset by capital flight). But both the rise in inflation and the worsening current account imply that the peso rate will fall further -- either voluntarily or involuntarily on Mexico's part.

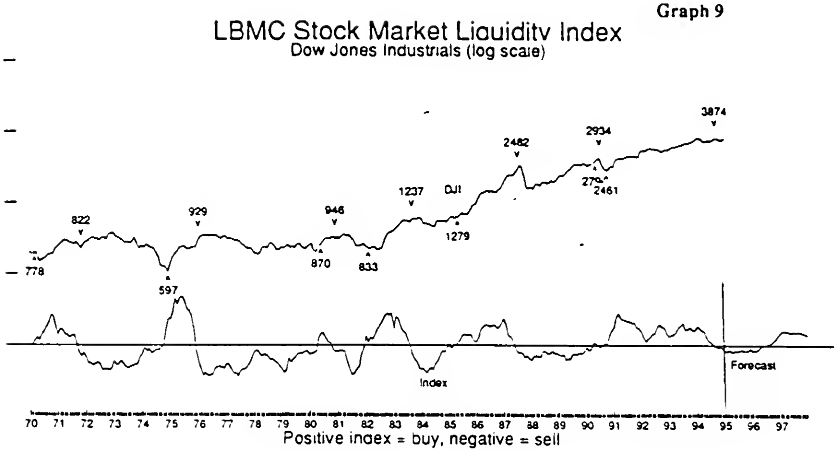
Our forecast assumes that the Mexican government, and foreign investors, jointly decide to return to a current account deficit of 5% of GDP. In this scenario, inflation rises to 40% in 1995 while the peso rate is steady for most of the year; then both inflation and currency depreciation settle down to about 25% in 1996. (This implies a peso rate of about 7 by the end of 1996.) But this is not a steady state, and inflation accelerates somewhat thereafter.

If U.S. and Mexican authorities succeeded in restoring a peso rate of 4.5 immediately, then inflation would be about 20-25% in 1995. But the rise in prices with a fixed exchange rate implies that the current account for the whole year would be about 5% of GDP in 1995, and rise back to 7% or 8% in 1996. This may or may not be a bad thing -- but it's nowhere near the IMF target of 3%.

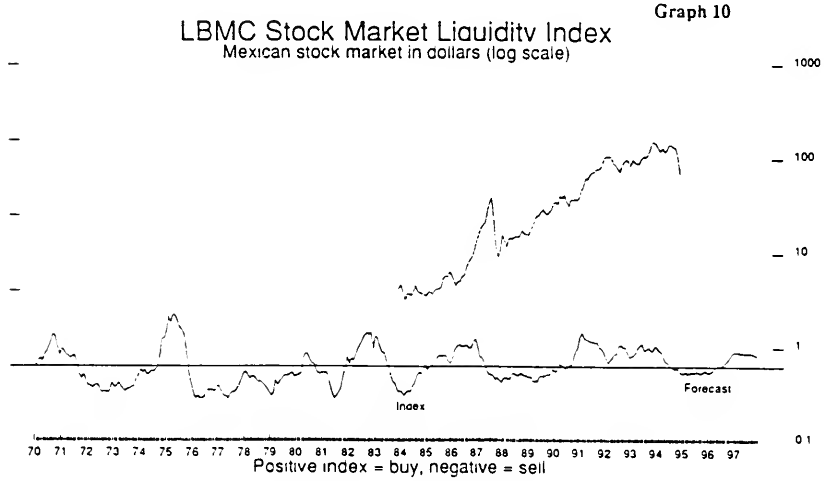
Fiscal and Wage Policy

The Mexican government also promises to achieve a small surplus in its budget and restrict credit through the development banks. It is difficult to see how this will be achieved, since the fall in investment and consumption relative to national saving, and the associated improvement in the current account, is normally associated with a recession, and a recession will increase the deficit. In normal economic theory, a larger budget deficit is associated with a higher real exchange rate, and a smaller budget deficit with a lower real exchange

Graph 9



Graph 10



rate. A larger demand for credit is supposed to attract foreign capital, either pushing up the nominal exchange rate or expanding the money supply and raising domestic prices.

However, Mexico does not bear this theory out at all. The relationship appears to be almost exactly the reverse: the current account is most in surplus when the budget is most in deficit, and vice versa. It's not so much that the theory is wrong in itself, but that the swing in private behavior is consistently in the opposite direction and swamps the effect of swings in the budget deficit (Graph 11).

But there is also supposed to be restraint in wage policy, in the form of price controls, a 7% guideline for wage increases, and a tax-based incomes policy. (In essence, President Carter's economic policy is to be applied to Mexico.) All of this will prove, we think, to be ineffectual, at least in holding down inflation. The moves are designed to increase the profit share of income by holding down wage costs; but Mexico does not have high unemployment, and once there are no qualified workers to hire, wages will have to rise at the same rate as profits. If the controls were effectively administered, it would create a sort of "repressed inflation" which would be reflected mostly in shortages. But it's more likely that the controls will be largely avoided.

Bailout Package Expansionary

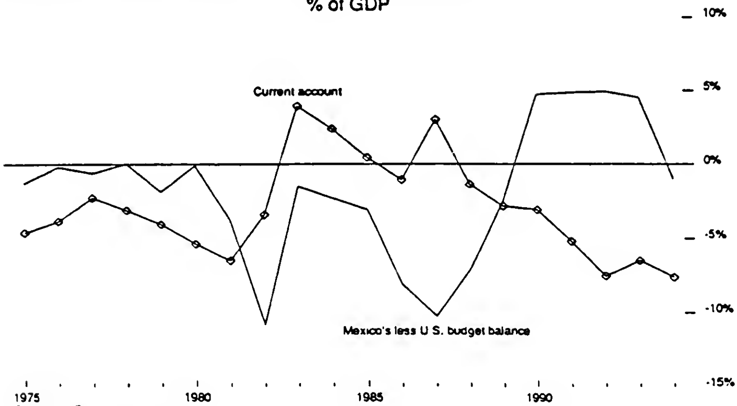
Then there is the peso bailout package. The total size -- about $50 billion -- is nearly 5 times as large as Mexico's monetary base. The package will, in effect, inject liquidity into Mexico's banking system and be part of the process of reflation. LBMC has measured what we call the World Peso Base -- the liabilities of the Bank of Mexico, not only in the form of currency and bank reserves held by Mexicans, but also those held by foreign monetary authorities in lieu of hard currency. The World Peso Base has been closely associated with the rate of Mexican inflation (Graph 12). But since this correlation is simultaneous, it's possible that the growth of the peso base is the result of the price level in pesos, rather than vice versa. Moreover, the peso base is known only after a sizeable reporting delay, so it is more useful for explaining what happened than in predicting the future. (The World Dollar Base leads the U.S. price level by over two years, so there is no ambiguity on that score about what causes U.S. inflation or the usefulness of data.)

But the argument here concerns the consistency of the IMF/Mexican forecast. The theory seems to be that inflation will stay down to 19% as long as the Bank of Mexico keeps credit expansion below 20%. There are two reasons to doubt this. First, purchases of pesos by official monetary authorities, of precisely the sort contemplated in the bailout package have, in the past, been associated with faster inflation than could be explained by the domestic Mexican money supply alone. Second, it's improbable that even domestic credit expansion will be kept below 20%, in the face of a 40% devaluation and a 40% inflation.

Moreover, the package is nearly twice the size of last year's current account deficit. As we noted earlier, the counterpart to a current account deficit is a capital inflow. But this is true of official capital as well as private capital. That is, a $50 billion influx of official capital would mean $50 billion worth of current account deficits. The only way to avoid this is if the $50 billion official inflow finances a $50 billion increase in official foreign exchange reserves or an equal private capital outflow. In the first case, none of the money could be used to bail out the Mexican banking system, while in the second, it would be paying off American investors and financing capital flight. Thus the package itself complicates and delays the adjustment it is ostensibly supposed to be promoting.

Graph 11

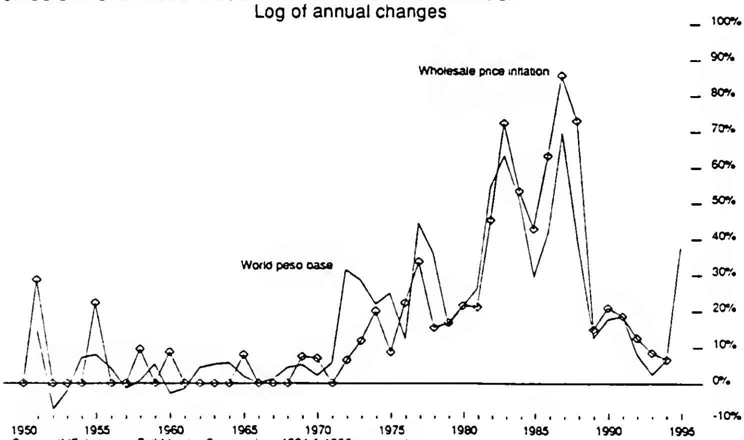
Mexico's Fiscal Policy & Current Account
% of GDP



Source: IMF
Lehrman Bell Mueller Cannon, Inc.

Graph 12

Mexico's World Peso Base & Wholesale Price Inflation
Log of annual changes



Source: IMF, Lehrman Bell Mueller Cannon, Inc.; 1994 & 1995 estimated.

Conclusion

In short, the situation is an unstable one. Many elements are still unclear -- above all, what the Bank of Mexico plans to try to achieve for the peso. But our analysis does permit us to predict the range of likely outcomes and test the consistency of official forecasts. At least two things seem clear: inflation will be higher than officials now predict, and a stable peso exchange rate, while technically feasible, is not politically feasible beyond late 1995, if that long.

Investors should have been able to step aside from Mexico based on Emerging Markets' prediction of a peso devaluation last October. Those with a long-term horizon can now purchase Mexican stocks about 40% more cheaply in dollar terms than before. But the near-term course of the market depends on policy choices which are not yet clear, and a liquidity "buy" signal is not expected before 1996.

PREPARED STATEMENT OF JEFFREY A. FRANKEL, Ph.D.

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MARCH 9, 1995

The "Obvious Peso Blunder" At Treasury

By now, many opinion columns have laid responsibility for the recent Mexican crisis at the doorstep of the Clinton Administration. They have appeared in the *Washington Post, Wall Street Journal, Washington Times,* and many other places. The mistake that the Mexican government made in 1994 regarding the peso was a "massive miscalculation,"[1] a mistake so egregious that it should have been obvious to all. It was so egregious that the U.S. Government should have acted to force a different policy on our neighbors. But Clinton Treasury officials were blind. They actually encouraged the Mexicans in their folly. This "may prove to be the worst mistake so far of the Clinton Presidency,"[2] "the worst foreign policy blunder of this Administration."[3] Perhaps there was even a conspiracy. The American taxpayer and the Mexican citizen, we are told, are now paying the cost.[4] Congressmen are demanding from the Administration "that someone should be held accountable" for its obvious blunder.

There is just one problem. Approximately half of these commentators claim that the mistake made by the Mexican government was to have devalued the peso. But the mistake that the other half of the commentators have in mind is that the Mexicans *failed to devalue the peso earlier*. Some players may be keeping their options open as to which mistake they want to pin on the Administration.

The first camp believes that devaluation is a medicine that obviously doesn't work, because it merely raises wages and prices proportionately. Bizarrely, they believe that devaluations are so wanton and unusual that when they occur, there must have been a conspiracy on the part of a small camp of "devaluationists," for example in the U.S. Treasury or the International Monetary Fund, to foist this discredited medicine on the gullible country in question.[5] They accuse the Clintonites and the IMF of aiding and abetting the peso travesty. [They say, for example, that Treasury officials were enthralled by an April 1994 Brookings paper by M.I.T. Professor Rudiger Dornbusch, urging that the Mexicans devalue.][6] According to reports in the *Wall Street Journal*, the Senators and Congressmen who have demanded documents from the Treasury and Fed to establish accountability have in mind that the error was in the direction of encouraging devaluation.

The second camp believes that the error was in *not devaluing earlier*. The growing Mexican trade deficit made it obvious that the country would have to devalue eventually, and the problem was made worse by postponing it. This second camp of critics either accuse the authorities of being asleep at the switch, or hint at a conspiracy between the Clinton Administration and the Salinas Administration to postpone the devaluation until after the NAFTA vote in the United States and the Presidential election in Mexico.[7] [They accuse the Treasury of arrogantly dismissing the Dornbusch warning.] A variant of this view is that, because some NAFTA opponents were on the list of those who pointed out the peso overvaluation ahead of time, it somehow follows that NAFTA caused the crisis.[8]

It is important to understand that there is no simple universal answer to the question whether or not countries like Mexico should maintain a fixed exchange rate. Tradeoffs are inevitable in the choice of exchange rate regime, as so often in economics (or, for that matter, in life). Furthermore, the question cannot be resolved by a belief in free markets or an aversion to government intervention, no matter the intensity of one's beliefs. On the one hand, free-marketeers, like Professor Robert Mundell or former Secretary Jack Kemp, will tell you that governments should get out of the business of manipulating the currency, and by this they mean that the government should keep the exchange rate constant. They are opposed to devaluations because they can lead to inflation. On the other hand, others, like Profes-

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[1] David Malpass, *Wall Street Journal*, January 11, 1995.
[2] Hobart Rowen, *Washington Post*, February 5, 1995.
[3] Paul Gigot, *Wall Street Journal*, February 24, 1995.
[4] E.g., Robert Kuttner, *International Herald Tribune*, January 21, 1995; William Greider, *Rolling Stone*, March 9, 1995; Christopher Whalen, *Washington Post*, February 5, 1995.
[5] Lawrence Kudlow, *Washington Times*; Robert Novak, *Washington Post*, January 30, 1995.
[6] Paul Gigot, *Wall Street Journal*, February 24, 1995.
[7] *Washington Post*: p. 1, February 13, 1995; Jim Hoagland, March 2, 1995; and Rowen, February 5, 1995.
[8] Kuttner, *International Herald Tribune*; Greider, *Rolling Stone*.

sor Milton Friedman or former Secretary Beryl Sprinkel, are equally fervent in their beliefs in free markets. They, too, believe that governments should get out of the business of manipulating their currencies, but for them this means that governments should let the currency float, to be freely determined in the marketplace. They think that the market is the best judge of the appropriate value of the currency, and that when the government intervenes to prop it up, it merely prolongs balance of payments deficits and makes the ultimate adjustment more difficult. Who is right? No universal answer is possible. Whether the advantages of a fixed exchange rate in a particular case outweigh the disadvantages depends very much on the specifics of that case.

In the case of Mexico, my own view is that the policy of anchoring the peso to the dollar in 1988 to bring down inflation was a very good one, but that the dangers of overvaluation grew over time. The primary reason for this is that, with some residual inertia remaining in Mexican inflation, Mexican goods gradually lost competitiveness on world markets over time. The trade deficit was the result.

The economic dangers came to outweigh the economic benefits perhaps around March–April 1994. Capital was no longer pouring into the country to finance the trade deficit as it had in 1993. Rather, money had begun to flee, largely as a result of the assassination of Presidential candidate Luis Colosio, in combination with increases in U.S. interest rates. In retrospect, this would probably have been a better time to devalue than on December 20, the date when the devaluation actually occurred.

One can certainly understand the decision of the Mexicans not to devalue in the spring or summer. The Mexicans, like Wall Street investors, figured there was no reason for the political instability of the first part of the year necessarily to continue. Indeed, the level of reserves stabilized in May and held steady. The Mexicans were justifiably proud of the progress they had made in bringing down inflation, by means of the exchange rate link to the dollar, and did not want to lose it. I suspect they thought they were in a new world, as a result of Mexican economic liberalization and NAFTA. If the Salinas Administration succumbed to the temptation to postpone unpleasant economic adjustments for political reasons, they would hardly be the first politicians to commit this sin.

Nevertheless—and, again, this is in retrospect—I come down on the side arguing that it would have been better to abandon the exchange rate commitment earlier in the year. By December 20, the country was about to run out of dollar reserves with which to buy unwanted pesos, so that there was literally no longer any choice but to let the value of the peso fall, whether by devaluation or by downward float.

Alternatively, if the Mexicans were really intent on maintaining their exchange rate peg, they should have tightened domestic credit more than they did throughout the year. By December 20, however, it was too late. There is nothing the Mexicans could have done, at this point, to avoid abandoning the peso policy.

In my view, it is especially foolish to talk of going back to 3.5 pesos to the dollar now. Given current prices in Mexico, its goods would be very uncompetitive on world markets at that exchange rate, and its large trade deficit would grow even larger. Those who argue in favor of going back to 3.5 apparently believe that Mexican *nominal* wages and prices would literally fall by 50 percent immediately after the peso was revalued. If that happened, it is true that Mexico would maintain competitiveness on world markets, which is what must happen if the country is to earn the dollars to pay back its debt. But anyone who thinks that wages and prices would in fact behave this way is, in my view, living in a dream world.

Furthermore, the Banco de Mexico does not have the reserves necessary to back up such a high value for the currency. If it tried to return to the old level of 3.5, it would certainly be forced to abandon the peg even more quickly than it did on December 20, as speculators rushed to sell pesos for dollars. These speculators would not wait around to see if Mexican workers and firms responded to the revaluation by cutting wages and prices by 50 percent. They would sell, sell, sell. Surely American taxpayers, who are already concerned that the January 31 support program will end up costing them money, would be very upset if these financial resources were, in the space of a few hours, converted into profits for speculators, leaving the authorities with nothing to show for their support program.

In my view, an exchange rate peg at 3.5 would probably fail regardless how high the Mexicans raised interest rates, and regardless how many bankruptcies among banks and firms they were prepared to tolerate. Extraordinarily high interest rates did not save Sweden or the United Kingdom from hemorrhaging reserves in the European currency crisis of September 1992. These governments, like so many others before them, were forced to abandon exchange rate commitments that had been fervently and sincerely proclaimed up to the bitter end.

I have no independent knowledge as to whether the U.S. Administration pushed the Mexicans in one direction, or the other, or neither in 1994. The most recent reports suggest that Treasury officials, throughout the fall, did in fact recommend devaluation to their Mexican counterparts. (In other words, they apparently did the opposite of what columnists like Hobart Rowen have surmised.) This, as I have said, seems to me, on balance, to have been the right policy. There are, of course, limits on the ability of one sovereign government to impose its recommendations onto another, even in the case of two such close neighbors as the United States and Mexico.

The IMF properly has the job of monitoring debtor countries. It is less clear, as yet, that the IMF questioned sufficiently the sustainability of the Mexican exchange rate anchor before December. (In other words, it may have done precisely the opposite of what columnists like Robert Novak have accused it of doing.) But, again, it is hard for an outsider to know.

My own view on the merits of the policy, or the views of other economists, are irrelevant to the point I wish to emphasize here. The point is that everyone likes to cast blame afterwards. The uninitiated newspaper reader would be likely to conclude that commentators unanimously consider the Clinton Treasury to have been negligent and incompetent. Only the careful reader will discern that half of the opinion columns claim that the negligence lay in the mistake of encouraging the Mexicans to devalue, while the other half claim that the negligence consisted of encouraging them to *delay* the devaluation.

From the viewpoint of a scholar of history or economics, it would indeed be interesting to know what, if anything, Washington officials told the Mexicans before December 1994. I understand that congressional investigators are seeking to discover this. Whatever the answers are when they become public, some observers will then say that the Clinton Treasury made an obvious blunder. I respectfully propose that those in Congress who think that the right policy was obvious are obligated to say what they believe Treasury should have done *before* they get the documentation on what Treasury actually did. Do they believe that the Mexicans should have been encouraged to devalue earlier, or do they believe that they should have been discouraged from devaluing at all?

PREPARED STATEMENT OF WALKER F. TODD*

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MARCH 9, 1995

Something Will Turn Up: The History of a Policy

This is merely an attempt to sketch in a preposterously summary fashion the history of several phenomena in twentieth-century American history that coincided in the current Mexican payments crisis. I have published several short writings on the current crisis, as well as two long studies cited in the attached readings list: If you or your staffs have the time and energy for them, you should read my "History of International Lending" (1991) and "Disorderly Markets" (1992), which attempt to explain for congressional audiences what the law, history, and economics have been for the American experience in lending abroad, with particular attention to Latin America, and for using the Treasury's Exchange Stabilization Fund (ESF) for purposes well beyond those for which it originally was intended. If you do not wish to read my writings on these topics, then I suggest the history of Latin American debt crises by Carlos Marichal (1989) and Martin Mayer's *The Fate of the Dollar* (1981), both of which also are mentioned in the attached reading list, as better substitutes than my own efforts.

To the extent that you care at all regarding the original intent of the framers of the U.S. Constitution with respect to the issues raised by the current U.S. and international response to the Mexican crisis, you are forced to choose sides in an irreconcilable set of conflicting analyses and policy prescriptions. It is downright silly (but admittedly might be politically convenient) to pretend that the irreconcilable easily can be reconciled. You can pretend that Mexican citizens should accept up to 10 more years of foreign-enforced austerity for the purpose of paying debts owed abroad, on top of 12 years of enforced austerity interrupted only by the elec-

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*Contact Walker F. Todd, Of Counsel, Buckingham, Doolittle & Burroughs, 1375 East Ninth Street, Suite 1700, Cleveland, Ohio 44114, 216–621–5300, fax 621–5440. The opinions expressed herein are entirely my own and not necessarily those of the law firm with which I am associated.

tion year of 1994, without resorting to emigration to escape the political and economic repressions of contemporary Mexico, but you would not accept such constraints for yourselves or your families, and you should not expect Mexicans to accept them either.

The irreconcilable constitutional problems arise from how you feel about matters like the appropriations clause or the power of Congress to regulate commerce with foreign nations. If you prefer to cede those matters constitutionally reserved to Congress to the Executive Branch instead (because doing so relieves you of politically distasteful recorded votes or displays your loyalty to the White House or the congressional leadership), then you might receive high marks in the Machiavellian handbook of how to be perceived to do well in Washington (something whose estimation outside the beltway you surely know already). But you also might be failing in your constitutional duty to approve **or reject and make it stick** Executive Branch initiatives in matters clearly reserved to the Legislative Branch. I would prefer that you reject the Clinton Administration's sequential varieties of Mexican bailout packages, including the present one, and that you make your rejection stick.

The world would not end if you blocked any further transfers of U.S. taxpayer-owned monies to or for the account of the Banco de Mexico (the central bank) or any other Mexican entity. Also, the world would not end if lawsuits were filed blocking such transfers. In fact, while it took the foreign exchange markets about 6 weeks to figure out that a blanket U.S. guarantee of the Mexican peso and the Canadian dollar is potentially quite harmful to the U.S. dollar itself, a not insignificant factor in the decline of the dollar in the last 2 or 3 weeks, the markets now know it and react accordingly.

Here are the hard, simplified lessons from this debacle:

1. Large-scale, long-term international loans (say, over $1 billion and for 10 years or longer) just are not repaid at original maturity dates on the originally scheduled terms. Even the United Kingdom has defaulted, devalued, rescheduled, suspended, or borrowed from the International Monetary Fund at least once every 10 to a dozen years or so, and U.S. drastic rescheduling or large-scale principal forgiveness have been fairly frequent for the United Kingdom. Should Mexican debt negotiators demand the same terms that we always have offered Mother England? And if not, why not? If Mexican politicians are no paragons of virtue, neither have United Kingdom politicians been such paragons throughout this century. **It is myopic to lend large-scale foreign obligors vast sums of new money to enable them to maintain debt service on outstanding stocks of debt—that simply increases the aggregate debts without easing the current debt service burden.**

2. The ESF has no vast supply of dollars in cash to throw at Mexico, Argentina, the U.S. dollar weakness, or anything else. It appears that the ESF had about $6 billion in cash several weeks ago but has lent all of it to Mexico. In addition, the ESF induced the Federal Reserve to lend $6 billion of the Fed's own money (without any statutory authority whatsoever) and may have made unimaginable promises to the IMF to induce it to advance $7.8 billion to Mexico in early February. The ESF had about $12 billion of IMF Special Drawing Rights, but it has cashed in $10 billion of them at the Fed for Special Drawing Rights Certificates several years ago. The ESF holds about $20 billion of Deutschmarks and yen, but it has no more dollars with which to support the peso. The ESF can raise substantial amounts of new money by either new congressional appropriations (but why would Congress want to do such a thing?) or by borrowing from the Fed via the so-called "warehouse," exchanging foreign currencies for the Fed's dollars. This is off-the-books financing that circumvents the appropriations clause and the principle of separation of powers. The broad interpretation spirit of Alexander Hamilton might be happy about such an outcome, but how are we doing with respect to the Rule of Law?

3. The Mexican people are not helped an iota by the monies advanced thus far. All the money has been used by the Banco de Mexico to smooth foreign exchange markets and the treasury bill (Tesobono) auctions. The typical (formerly) middle class person has not seen a centavo of the U.S. and multinational assistance packages. The governing party, the Institutional Revolutionary Party (PRI), in power for more than 65 years, is thoroughly corrupt and should be abolished. Remaining unspent assistance should be channeled into a currency board aimed at stabilization of purchasing power of the peso in a no-deficits fiscal posture of the central government. The monies spent in currency interventions are untraceable, and no proper accounting records are kept for them, north or south of the border. The fiction of oil receipts as collateral for advances may pacify politicians looking for protection from criticism for wasting the taxpayers' money (about $300 for every individual tax return if $40 billion is spent), but no Mexican citizen is happy about this arrangement. You would not be happy either if President Clinton pledged U.S. oil export

receipts (which are substantial) to Japan in exchange for a new loan of yen with which to play the foreign exchange markets to prop up the dollar, especially if, meanwhile, the domestic policy mix were worse than before the pledge.

More, much more, could be said, but this is all that time allows for now. The whole idea of luring foreign debt investors into Mexico was myopic (can I say "stupid" in the U.S. Senate?) in the context of twentieth-century financial history and the purposes for which the Bretton Woods institutions were created in 1945. Senior Treasury and Federal Reserve officials either knew or should have known the true condition of Mexico's external finances at all times since October 1993. It should not have taken a series of political murders in 1993 and 1994 to persuade senior U.S. policymakers that the PRI is a corrupt organization, but they now claim not to have known that (or not to have been willing to do anything about it) before late February 1995. The ESF is being used for purposes for which it never was intended, and the Fed is funding those purposes without proper authorization. Congress could block the transfers but so far has been unwilling to act. Institutional investors and wealthy Mexican friends of the PRI are being bailed out by foreign exchange market interventions, but the beneficiaries of the bailouts are attempting to hide behind the skirts of the widows and orphans who hold high-risk mutual funds (since when did such investments become appropriate for widows and orphans?).

Perhaps if we keep the current, unsustainable process going a while longer, something positive will turn up. But which one of you wishes to be the first to say that to your constituents as you sit back and watch the Treasury and the Fed transfer up to $300 per tax return to Mexican entities?

Suggested Readings on Big International Bailouts and Domestic Loan Guarantees

1. Walker F. Todd, "A History of International Lending," in George Kaufman, ed., *Research in Financial Services: Private and Public Policy*, vol. 3 (1991), pp. 201–289, Greenwich, CT: JAI Press Inc. Note that this is a hardbound monograph series, NOT a journal. An earlier version of this article appeared in *George Mason University Law Review*, vol. 11, no. 4 (summer 1989), pp. 1–72.
2. Carlos Marichal, *A Century of Debt Crises in Latin America: From Independence to the Great Depression, 1820–1930*, Princeton, NJ: Princeton University Press, 1989.
3. John Maynard Keynes, chapter derived from *The Economic Consequences of the Peace* (1919), in *Essays in Persuasion*, pp. 7–45, New York: W.W. Norton, 1963.
4. Walker F. Todd, "Disorderly Markets: The Law, History, and Economics of the Exchange Stabilization Fund and U.S. Foreign Exchange Market Intervention," in George Kaufman, ed., *Research in Financial Services: Private and Public Policy*, vol. 4 (1992), pp. 111–178, Greenwich, CT: JAI Press Inc. Note that this is a hardbound monograph series, NOT a journal.
5. H.R. Haldeman, *The Haldeman Diaries: Inside the Nixon White House*, CD-ROM version, entries for August 1971, Santa Monica, CA: Sony Imagesoft, 1994.
6. Martin Mayer, *The Fate of the Dollar*, New York: Signet (paperback), 1981.
7. Richard N. Gardner, *Sterling-Dollar Diplomacy in Current Perspective*, New York: Columbia University Press, 1980.
8. Jean LeCerf, *L'Or et les monnaies* [Gold and currencies, in French], Paris: Gallimard, 1969.
9. Walker F. Todd, "The Federal Reserve Board Before Marriner Eccles (1931–1934)," Federal Reserve Bank of Cleveland, *Working Paper* No. 9405 (April 1994). Copies of this and other Federal Reserve Bank of Cleveland publications may be obtained by calling (216) 579–2048.
10. Walker F. Todd, "The History of and Rationales for the Reconstruction Finance Corporation," Federal Reserve Bank of Cleveland, *Economic Review*, 4Q1992, pp. 22–35.
11. Marvin Goodfriend, [this is from memory—it may be wrong] "A Note on a Treasury–Fed Credit Accord," in *Journal of Money, Credit and Banking*, vol. 26, no. 3 (August 1994).
12. Anna Jacobson Schwartz, "The Misuse of the Fed's Discount Window," Federal Reserve Bank of St. Louis, *Review*, vol. 74, no. 5 (September/October 1992), pp. 58–69.

A Position Paper on Mexico

JANUARY 7, 1995

If the United States, Canadian, and other foreign financial authorities arrange a new, increased credit line for the Bank of Mexico (Banxico) to defend the peso, the consequences will be disastrous for both Mexico and its North American Free Trade Agreement (NAFTA) partners. There currently is no credible Mexican fiscal or monetary policy to defend, and without such a policy, the best solution temporarily would be to continue to allow the peso to float *without* intervention by Banxico. A large, new credit would be nearly impossible for Mexico to repay from existing foreign exchange-generating resources in the near term and already has been accompanied by foreign creditors' demands for a renewed austerity regime in Mexico intended to shrink imports and maximize exports.

It is inconceivable that any International Monetary Fund (IMF) or World Bank assistance package intended to be a principal source of repayment of a U.S.–Canadian or other international credit line could avoid austerity measures. Yet, as a *Wall Street Journal* editorial noted on December 22, 1994, with insight unusual for the *Journal* in any matter regarding Mexico, austerity, wage-and-price freezes, and the like are a misguided response to the present crisis: Mexican small- and medium-sized businesses need the capacity to grow, which the devaluation of the peso apparently has provided and which lower peso interest rates could provide, and Mexican workers need the capacity to earn higher real wages in peso terms, which stabilization of the peso at a new, lower level could provide. The *Journal*'s principal recommendation for reform, an expanded privatization program with the proceeds used to purchase pesos in the open market, is not bad at all and resembles the recommendations originally made (but, alas, not followed) for policy reform in the former Soviet Union after 1991.

Lasting policy reform in Mexico requires avoidance of any large, new, official foreign borrowings, especially borrowings with austerity strings attached, credible reform of the fiscal mechanism (increased reliance on either a broad-based tax on consumption, like a value-added tax, or effective taxation of newly privatized companies), and the permanent abolition of the Institutional Revolutionary Party (PRI). The present chaos in Mexico is not the fault of the Zapatistas in Chiapas or of the political opposition: It was caused by the politically driven pursuit of outdated fiscal and monetary policy objectives decided at the highest levels by the PRI itself over the last 3 years. It is difficult to see how the chaos would be any greater if the Party of the Democratic Revolution (PRD) had won the August 1994 elections or if the Zapatistas were in control of Mexico City. Why is a peso value of 5.8 per dollar all right for the PRI but not all right for the PRD? Why is a $30 billion current account deficit all right for the PRI but not all right for the PRD?

The political opposition in Mexico, including the National Action Party (PAN), should unite to confront the PRI with the following four demands for policy reform:

1. **National unity government.** To stabilize the political situation in Mexico, it is imperative that the opposition parties be made at least equal partners in the governance of Mexico. A power-sharing arrangement of one-third, one-third, one-third for each of the three major parties should follow. It could be either 2 years for the PRI (after which the PRI would be abolished), followed by 2 years for the PAN, followed by 2 years for the PRD, or a 6-year power-sharing arrangement in which all cabinet ministries would be rotated among the three parties for the balance of this *sexenio*, with the important ministries (Finance, Interior, Attorney General, Foreign Affairs, and Gobernacion) outside PRI control for the final 2 years of the *sexenio* leading up to the next Presidential election. A power-sharing arrangement and the abolition of the PRI should be the minimal conditions of the opposition for cooperating with any financial stabilization program now. If PRI members wish to constitute a new party under a new name, without using the national colors as its symbol, then let them do so. But the PRI, like the former Communist Parties of Eastern Europe and the Soviet Union, has forfeited all moral authority to continue to govern.
2. **Investigations aimed at discovering and publicizing the truth.** Chile recently confronted this dilemma and resolved it more or less satisfactorily: After the Pinochet regime left power, the political opposition agreed there would be no politically-based prosecutions for crimes committed by the outgoing government. However, it was agreed that there would be thorough, definitive investigations to determine the truth about events of the Pinochet years, with full publication of the findings of the truth commissions. The opposition should insist on the establishment of similar commissions in Mexico, totally divorced from the PRI, with PRI members allowed to present evidence but not to serve

on the truth commissions. The commissions should be given adequate budgets and a mandate of 3 years to present findings to the National Congress, with those findings to be published at least 2 months before the next legislative elections. Topics that must be investigated to establish a credible basis for the renewal of the Mexican constitution include:

—The history of the establishment of the foreign central bank credit lines in 1967 and their subsequent uses in the election years 1976, 1982, 1988, and 1994, as well as in 1986. Who received the effective use of these funds? How were the loans repaid?

—The assassinations of the Archbishop of Guadalajara, Donaldo Colosio, and Ruiz Massieu, as well as the assassinations of Mexican journalists since 1982.

—The massacre of the student demonstrators in the central plaza in Mexico City in 1968.

3. **Exposure of connections between drugs trafficking and money laundering in Mexico, the Mexican political establishment, and foreign intelligence services.** If, as increasingly seems to be the case, the international drug cartels and money launderers finally have discovered Mexico as a center of operations, then the Mexican public should be told about those operations. Among other interesting episodes, the underground tunnel between Tijuana and San Diego that was "discovered" in the late summer of 1993 should be explained. Who built the tunnel? Who financed it? Who knew about it? What did the United States authorities know about the tunnel, the cross-border drugs trade, money laundering by United States and Mexican banks and investment banks, and complicity of foreign intelligence services in those activities? A separate truth commission should be appointed to investigate and publish a report on these matters.
4. **Reform of the central bank's accounting practices.** Banxico should be held to the same accounting standards as the other central banks covered by NAFTA. Banxico should prepare a detailed balance sheet that is published weekly. It should publish its foreign exchange and precious metals reserves weekly, showing the methods used to calculate those amounts. The currency composition of the reserves should be published. Loans to the banking system and others should be disclosed. Intervention in the stock exchange should be entirely prohibited. Detailed trading records showing individual trades of foreign exchange and precious metals should be made available for inspection after 1 month by any journalist, teacher, academic writer, lawyer, or accountant authorized to practice his profession by any of the NAFTA signatory countries or any of its member states. Banxico should formally request that the Federal Reserve and Bank of Canada also open their foreign exchange trading records for the Mexican peso to similar inspections after similar delays and should publish the replies to those requests received from the U.S. and Canadian authorities.

If the Mexican opposition political parties can be mobilized to demand these political reforms aimed at establishing the Rule of Law in early 1995 in Mexico, then the economic pain caused by the devaluation of the peso will have been worthwhile, for the Mexican public even if not for some classes of foreign investors. It is important not to forget to pursue objectives aimed at establishing the Rule of Law even as purely financial reform measures are pursued.

MEXICAN EUROBONDS OUTSTANDING BY ISSUER

(Notable issuers only)

Note: This table shows initial principal amounts only; coupon rates generally were in the 8.0% to 11.25% range. The bulk of new Eurobonds were issued in 1991 and 1992. The latest maturity is in April 2004. Final maturity dates of last maturing issues are shown here. Amounts are in millions of dollars.

PRI	Banco Nacional de Comercio Exterior (BANAMEXT) 2-04-2004	$3,404.2
PRI	Banco Nacional de Mexico (BANAMEX) 4-01-2000	1,290.0
PRI	Bancomer 5-23-2001	1,580.0
PRI	CEMEX 8-31-2000	2,996.0
PRI	CEMEX & Tolmex (now a subsidiary of CEMEX) 5-22-1996	425.0
PRI	Tolmex (now a subsidiary of CEMEX) 11-16-2003	400.0
PRI	Grupo Televisa 11-09-1997	400.0
PUB	Nacional Financiera (NAFINSA) 7-15-2002	2,526.5
PUB	Petroleos Mexicanos (PEMEX) 10-13-2003 (Note: My list shows one maturity of $250.0 million on 3-12-2024, but this might be 3-12-2004).	4,169.0
PUB(?)	Transportacion Maritima Mexicana (TMM) and TMM Financial Services (subsidiary) 5-15-2003	875.0
PUB	United Mexican States (UMS or Hacienda) 9-15-2002	1,457.5
	Total listed here	$19,523.2

Estimated total public and private Eurobonds: $29.0 billion from issuers appearing on lists already prepared; estimates of $40 to $50 billion would not be improbable.

NOTE: As far as I know, **none** of these Eurobond issues has been analyzed in the official discussions on refunding Mexico's external debt. But they cannot possibly be ignored, because the issuers are either the state itself or the largest privately held companies in Mexico.

LIST OF EUROBONDS OF MEXICAN ISSUERS MATURING IN 1995

By Walker F. Todd and anonymous research assistants

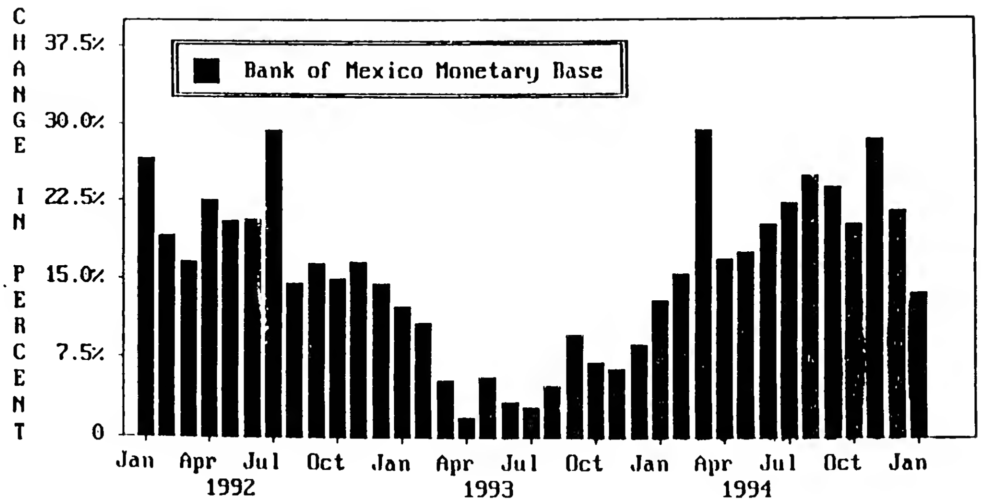
January 29, 1995

PRI=nominally private issuer; PUB=nominally governmental issuer; amounts in millions of dollars

PRI	Tubos de Acero de Mexico (TAMSA)	$50.0	1-30-95
PRI	CEMEX	171.0	3-15
PUB	Petroleos Mexicanos (PEMEX)	58.9	4-20
PRI	Tamtrade (may be a subsidiary of TAMSA)	33.0	4-20
PUB	PEMEX	100.0	4-24
PRI	Aeromexico	100.0	6-10
PRI	Cremi (Banco Cremi Union?)(PUB admin.)	150.0	6-13
PRI	Banco Internacional	50.0	6-25
PUB	Nacional Financiera (NAFINSA)	150.0	6-27
PUB	NAFINSA	90.2	6-27
PRI	Banco Cremi Union (PUB administration)	150.0	6-29
PRI	Sidek International Finance	50.0	7-05
PRI	Banco Nacional de Comercio Exterior (BANCOMEXT)	60.1	7-16
PRI	BANCOMEXT	60.1	7-18
PUB	NAFINSA	100.0	8-02
PUB	NAFINSA	100.0	8-05
PRI	Grupo Synkro, SA de CV	50.0	10-07
PRI	CEMEX	50.0	10-10
PRI	Iusacill	45.0	11-13
PRI	Iusacill	15.0	11-19
PRI	Cydsa	50.0	11-24
PRI	Banco Cremi Union (PUB administration)	50.0	11-30
PUB	PEMEX	100.0	12-13
PRI	Sidek International Finance	50.0	12-21
PUB	PEMEX	100.0	12-31
	Total	$1,933.4	

Note: There may be some double-counting in this list, which was prepared from unofficial Mexican sources. For example, the $100.0 million Eurobond for NAFINSA maturing 8-05-95 may be the same item as the 8-02-95 maturity Eurobond. But all possible double-counts in this list total only $265.3 million, leaving at least $1,668.1 million to be dealt with during 1995.

MONETARY POLICY IN MEXICO



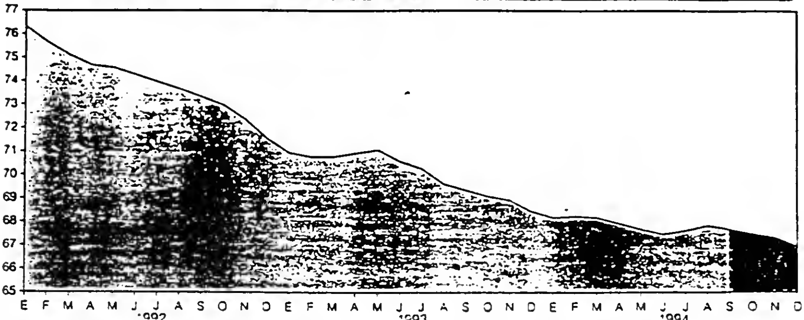
Notes: The chart shows year-over-year percentage changes in the monetary base of the Bank of Mexico. Sources of the monetary base are currency and deposits by banks in the Bank of Mexico. Underlying data are millions of current pesos.

Sources: Bank of Mexico; Heinemann Economic Research

INDICE DEL TIPO DE CAMBIO REAL / REAL EXCHANGE RATE INDEX

1978 = 100

En Base a Precios al Consumidor / Based on Consumer Prices

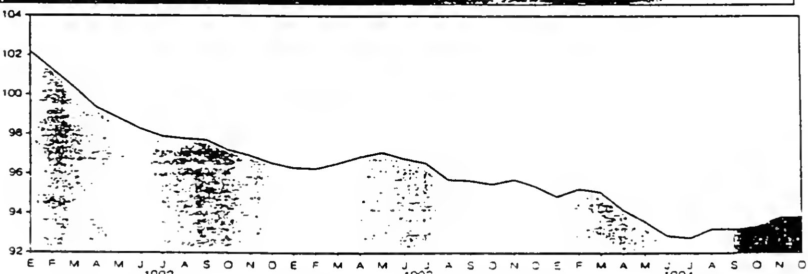


	Enero January	Febrero February	Marzo March	Abril April	Mayo May	Junio June	Julio July	Agosto August	Septiembre September	Octubre October	Noviembre November	Diciembre December
1992	76.3	75.6	75.1	74.7	74.5	74.3	73.9	73.6	73.3	72.9	72.3	71.5
1993	70.9	70.8	70.8	70.9	71.1	70.6	70.3	69.6	69.3	69.1	68.9	68.4
1994	68.2	68.2	68.2	67.9	67.7	67.5	67.6	67.8	67.7	67.5	67.3	67.0

INDICE DEL TIPO DE CAMBIO REAL / REAL EXCHANGE RATE INDEX

1978 = 100

En Base a Precios al Productor / Based on Producer Prices

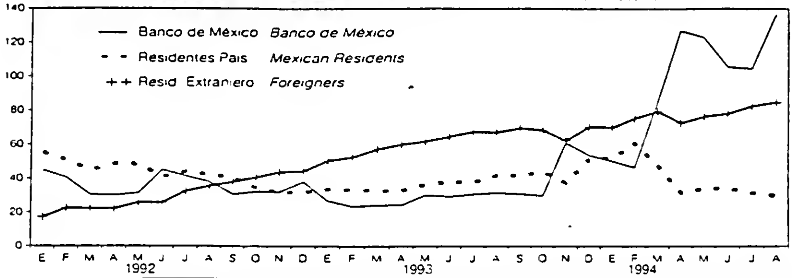


	Enero January	Febrero February	Marzo March	Abril April	Mayo May	Junio June	Julio July	Agosto August	Septiembre September	Octubre October	Noviembre November	Diciembre December
1992	102.2	101.3	100.4	99.4	98.8	98.3	97.9	97.3	97.7	97.2	96.9	96.6
1993	96.3	96.3	96.5	96.9	97.1	96.8	96.6	95.7	95.7	95.5	95.7	95.4
1994	94.9	95.3	95.1	94.2	93.6	92.9	92.9	93.2	93.2	93.4	93.8	93.9

Estimado a partir de Septiembre 1994 — *Forecast from September 1994*

TENENCIAS DE VALORES GUBERNAMENTALES POR SECTOR
Miles de Millones de Nuevos Pesos

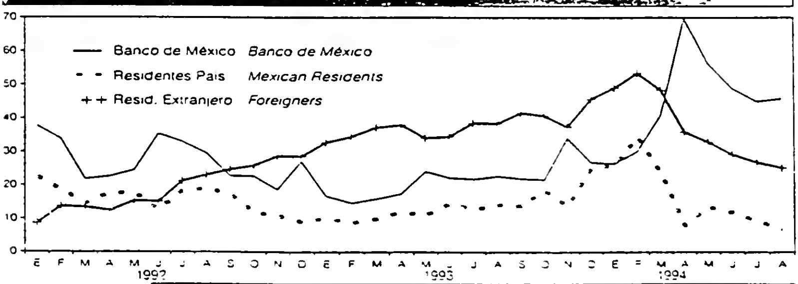
HOLDINGS OF GOVERNMENT SECURITIES BY SECTOR
Billions of New Pesos



		Enero *January*	Febrero *February*	Marzo *March*	Abril *April*	Mayo *May*	Junio *June*	Julio *July*	Agosto *August*	Septiembre *September*	Octubre *October*	Noviembre *November*	Diciembre *December*
Banco de México	1990	26 86	23 53	24 39	24 45	30 16	29.26	30 74	31 55	30 70	29 79	60 68	53 36
Banco de México	1990	50 07	46 46	84 81	127 02	123 09	105 58	104 48	105 [illegible]				
Residentes País	1990	33 70	33.51	32 82	32.86	36 36	37 95	37 71	41 70	41 74	43 84	37 05	51 24
Mexican Residen	1990	52 00	60 67	47 81	31 68	24 07	24 [illegible]	31 54	29 34				
Resid. Extranjero	1990	50 56	52 62	57 24	59.89	61 65	64 53	67 39	67 [illegible]	69 55	68 11	61 98	70 24
Foreigners	1990	69 65	75 22	79 29	72 57	76 34	79 04	82 43	84 [illegible]				

TENENCIAS DE CETES POR SECTOR
Miles de Millones de Nuevos Pesos

HOLDINGS OF CETES BY SECTOR
Billions of New Pesos



		Enero *January*	Febrero *February*	Marzo *March*	Abril *April*	Mayo *May*	Junio *June*	Julio *July*	Agosto *August*	Septiembre *September*	Octubre *October*	Noviembre *November*	Diciembre *December*
Banco de México	1990	16 69	14 61	15 95	17 43	24 07	22 14	21 78	22 70	21 33	21 56	34 03	26 76
Banco de México	1990	26 46	20 13	40 93	69 79	56 42	49 93	44 98	45 34				
Residentes País	1990	10 16	8 66	9 85	11 93	10 98	14 52	12 77	14 17	9 30	18 45	13 80	25 03
Mexican Residen	1990	26 09	34 49	23 77	9 12	13 53	11 96	9 06	5 95				
Resid. Extranjero	1990	22 75	24 49	37 20	38 01	34 01	34 51	38 54	38 46	41 51	40 53	37 42	45 71
Foreigners	1990	49 07	53 45	48 35	35 90	32 93	29 16	26 33	25 [illegible]				

Clinton

JOHN J. LAFALCE, NEW YORK
CHAIRMAN

JAN MEYERS, KANSAS

Congress of the United States
House of Representatives
103d Congress
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515-6315

June 9, 1993

The President
The White House
Washington, D.C. 20500

Dear Mr. President:

Much has been debated about the North American Free Trade Agreement. Proponents and opponents have marshalled their arguments and campaigned for their positions. There is one issue, however, about which there should be universal agreement and that is the necessity for exchange-rate stability among the NAFTA countries' currencies.

We are embarking on a critical experiment with the NAFTA proposal. We are dealing with numerous unknowns, particularly the impact of joining the world's wealthiest industrial economy with that of a populous developing country. The agreement's effects on U.S. jobs, illegal immigration, and trade flows are subject to studies and speculation. We do know, however, that currency relationships in a free-trade area are central to its functioning and effectiveness. Despite this fact, few voices have been heard about the peso-dollar relationship and exchange-rate risk.

On May 20, I chaired a Small Business Committee hearing on this issue and prospects for a sharp peso devaluation. I noted then that since 1981, the peso has fallen from 25 to the dollar to a current 3,200 pesos to the dollar. Mexico's exchange-rate policy has gradually devalued the peso since January 1989, and in January of this year, the Mexican Government created the New Peso whose value is NP3.27:U.S. $1.00. Economists at the hearing suggested that the peso is overvalued by 10-20 percent, and some believe a major devaluation is inevitable.

During consideration of the U.S.-Canada FTA, I discussed the importance of exchange rates to the agreement. If you trace the flows of trade between the United States and Canada, you will see a direct relationship to the values of the American-Canadian

dollars and the type of trade account we are running--there is perfect symmetry. At the hearing on May 20, Dr. John Williamson, a recognized expert on monetary policy at the Institute for International Economics, told the Committee that he wrote an appendix to the Institute's first study on the FTA urging that an agreement be included covering the monetary dimension of the FTA. I am enclosing a copy of that appendix. Dr. Williamson reported that when IIE's study on NAFTA was in process, the monetary issue "slipped through the cracks," but he sympathized with my thinking on the desirability of having a monetary dimension to a NAFTA agreement. He said he shared my concern about the "crucial importance of getting exchange rates right as part of macroeconomic policy and a component of a free trade area."

I believe it imperative that the United States pursue a fourth supplemental agreement that recognizes the importance and impact of exchange rates on the operation of NAFTA. It would be prudent to make provisions in NAFTA for coordination to achieve currency stabilization, perhaps creating a mechanism that would allow for consultation, coordination, and corrections if necessary.

I urge you to give serious consideration to the central importance to NAFTA of monetary policy and exchange-rate coordination, and include in your current negotiations of side agreements a provision that allows for such coordination and consultation.

Sincerely,

JOHN J. LaFALCE
Chairman

Enclosure

JUL 22 REC'D

SECRETARY OF THE TREASURY

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

July 20, 1993

The Honorable John J. LaFalce
Chairman
House Committee on Small Business
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

I am writing in response to the letters on NAFTA and exchange rates which you sent to President Clinton, Ambassador Kantor and myself. I understand the concern you expressed that our trading partners might attempt to undermine the benefits achieved through trade agreements by manipulating their currencies to seek an unfair competitive advantage. In the case of NAFTA, however, I believe this concern is misplaced and that a side agreement on exchange rates is not needed.

Neither Mexico nor Canada has a history of using competitive devaluations in order to achieve trade advantages. Mexico, on the contrary, has traditionally sought to maintain stable exchange rates as a foundation for price stability and sustainable economic growth and has generally resisted pressures for devaluation, sometimes at great cost. NAFTA, by bolstering investor confidence in Mexico, will help to encourage capital inflows needed to finance imports (largely from the United States) and support the peso.

As IMF members, moreover, Mexico and Canada have agreed to avoid exchange rate manipulation to gain unfair competitive advantage. Treasury monitors developments in exchange rates closely both as part of the IMF annual reviews of our trading partners and, as you are aware, under Article 3004 of the 1988 Omnibus Trade Act.

I would also like to point out that senior Treasury Department officials consult regularly with our Mexican and Canadian counterparts on macroeconomic issues, including fiscal and monetary policy and, as appropriate, exchange rate policy. In Canada's case, this occurs primarily in the context of the G-7 coordination process. In the case of Mexico, consultations on these issues take place in a variety of venues, including the U.S.-Mexico Binational Commission and the IMF and World Bank annual meetings, in addition to meetings to discuss specific issues. I anticipate that these consultations will occur on an even more regular basis after NAFTA is implemented and the economic integration of our three countries continues.

By creating an environment in which goods, services, and capital move more freely, NAFTA should increase the prospects for non-inflationary growth in the U.S. and Mexican economies and thus also for a more stable exchange rate for our currencies. Indeed, anticipation of the NAFTA has been a significant factor in encouraging the emergence of a positive U.S. trade balance with Mexico while also helping to slow the depreciation of the peso.

Sincerely,

Lloyd Bentsen

The New York Times, February 2, 1995

HEADLINE: **MEXICAN RESCUE** PLAN: WASHINGTON;
Rescue: Durable Or Brief?

BYLINE: By DAVID E. SANGER, Special to The New York Times

DATELINE: WASHINGTON, Feb. 1

BODY:

President Clinton's move to sidestep Congress and order emergency credits to Mexico halted a monthlong run on the peso, but it left Congressional critics and reluctant American supporters worrying that the bailout's success would prove temporary.

A debate over the solidity of the plan arose today as the International Monetary Fund met into the night in Washington and finally approved an emergency $17.8 billion in medium-term loans.

Officials said the money would be available immediately to help the Mexican Government keep from defaulting on $40 billion in bonds and other liabilities that come due this year. Approval came dispite bitter complaints by Germany and France that they had not been consulted by the White House and that the money might come out of aid to Eastern Europe and Russia.

On Capitol Hill, opponents of any American involvement in Mexico's bailout threatened hearings, focusing on what the Administration knew about Mexico's distress last year and how President Clinton diverted $20 billion in Treasury Department funds -- intended to stabilize the dollar on world markets -- to provide Mexico with emergency loans.

Not surprisingly, some of the harshest criticism came from Patrick J. Buchanan, the conservative columnist and the leader of the effort to kill any aid to Mexico.

"The looting of America, on behalf of the new world order, has begun," said Mr. Buchanan, who also opposed the North American Free Trade Agreement with Mexico and Canada a year ago. "Never again should a President be allowed to disregard the will of Congress to raid the U.S. Treasury to bail out Wall Street banks or a foreign regime."

Senator Phil Gramm, the Texas Republican and an expected contender for his party's nomination for President in 1996, said Mr. Clinton was "filling a bucket that is full of holes."

But the President's action was defended by an unlikely ally: Newt Gingrich, the Speaker of the Republican-controlled House of Representatives.

"The President exercised his authority," Mr. Gingrich said today. "He took a tremendous burden on his shoulders. He did what key leaders felt was necessary.

"I think people at a minimum should recognize the President had the courage to do what he was being told by the very sophisticated experts was vital to reinforce international markets."

To sell the President's action, Treasury Secretary Robert E. Rubin assured skeptical Republicans and Democrats on Capitol Hill that Mexico had agreed to fundamental economic reforms and would be held to those commitments.

The reforms, spelled out in a letter from Mexican officials to the I.M.F. last week, include a more independent central bank, controls on credit expansion, continued privatization of Government-owned industry and relaxation of many of economic controls, including prohibitions on foreign investment in Mexican banks.

But Treasury officials acknowledged today that while they had talked about the loan conditions in general terms with Mexico, there was nothing on paper. Already the conditions are being described in Mexico in far more lenient terms than they are in Washington.

For the American economy, the most important question is whether the bailout strengthens the peso. Its current level makes American goods 35 percent more expensive in Mexico than they were in December, and Mexican goods that much cheaper in the United States.

The current rate also seems to many economists to be likely to encourage far more illegal immigration across the border as Mexicans seek jobs that pay in dollars.

Mr. Clinton offered one of his most impassioned defenses of his action on Tuesday night in Boston.

"I know the surveys say that by 80 to 15, or whatever they said, the American people either didn't agree or didn't understand what in the world I'm up to in Mexico," he declared. "But I want to say to you, it might be unpopular, but in a time of transition it's the right thing to do."

Some of the harshest criticism of the Administration's action today came from European capitals, which were taken by surprise by the International Monetary Fund's decision -- under strong pressure from the White House -- to add $10 billion in aid to Mexico. That is in addition the $7.8 billion that the I.M.F. approved last week.

An I.M.F. official in Washington said some European governments were concerned that the fund's remaining resources might not be enough to deal with crises in other parts of the world.

THE MEXICAN PESO CRISIS

FRIDAY, MARCH 10, 1995

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10 a.m., in room SD–G50 of the Dirksen Senate Office Building, Senator Alfonse M. D'Amato (Chairman of the Committee) presiding.

OPENING COMMENTS OF CHAIRMAN ALFONSE M. D'AMATO

The CHAIRMAN. We are reconvening this hearing which started yesterday. And rather than giving opening statements, which most of the Members have given yesterday, I am going to do something that is unusual in the Senate that should be more prevalent.

Let's hear from the witnesses first, because, after all, that is why we asked them to come.

Senator MACK. It is a remarkable idea.

The CHAIRMAN. It is different.

Because of some time constraints both former Congressman and former Secretary of Housing and Development Jack Kemp has, we have reversed the panels and are asking that panel to testify first.

That panel consists of former Secretary Kemp and Paul Volcker, the former Chairman of the Board of Governors of the Federal Reserve.

Mr. Volcker, Paul, we thank you for being with us, and we would ask you to begin.

OPENING STATEMENT OF PAUL A. VOLCKER FREDERICK H. SCHULTZ PROFESSOR, INTERNATIONAL ECONOMIC POLICY, PRINCETON UNIVERSITY; CHAIRMAN, JAMES D. WOLFERSOHN, INC., NEW YORK, NY; AND FORMER CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, WASHINGTON, DC

Mr. VOLCKER. Thank you, Mr. Chairman and Senators. I have a very brief statement, and I will just make a couple of points as an introduction to what will be a more general discussion.

The first point is simply that: Whatever the arguments and questions about the specific approaches we have taken and Mexico has taken, the United States has had, and continues to have, a strong national interest in providing transitional financial support to Mexico as it struggles with what is very clearly a major financial crisis.

I don't think I have to elaborate on the importance of growth and stability in our southern neighbor for a variety of reasons, but I

would point out that it is not just prospects for Mexico or Mexican-American relations that are at stake.

Mexico has developed, in recent years, policies toward its internal markets, toward encouraging private enterprise, toward outward-looking policies, and toward monetary stability that have been a model for other emerging markets and developing economies, certainly in Latin America, but also elsewhere.

So, while there have been mistakes made in this process—mistakes not just in Mexico, I might say—and a very heavy price is being paid for those miscalculations, it is extremely important that we lay a new base for restoring stability and progress so that this model of economic development can continue and be reinforced.

I simply do not think that is possible under the current circumstances without assistance, financial assistance, from the United States and from multilateral organizations and other countries.

You have what has been a clear reversal of private financing, which was very ample earlier. You have enormous pressures on the domestic financial markets in Mexico, and the changes that they have to make in policy and economic adjustments—and I think they announced some promising measures yesterday—can't realistically be made and carried through in speed without some external support.

Now, we can argue about the nature and size of that support, what the United States should have done, what the IMF should do, and what other multilateral institutions should do, but I do not think it is really disputable that it was appropriate for the United States to act, and act with great dispatch.

That brings me to my second point I would like to make here at the start: The United States has enormous size and power in the world still, and with that power goes opportunities and responsibilities. The first responsibility is to ourselves, to maintain our strength and stability. But we can influence the kind of world in which we live. We can influence the policies and prospects of our trading partners.

In that context, I think any American Administration must have readily at hand both the authority and capacity to react fast and effectively to sudden threats to external financial stability, threats to the kind of open economic order upon which we are all dependent.

I think it is idle to think we can predict the timing of those threats or their magnitude, and that is why, for many years, the financial resources available in the Treasury's Exchange Stabilization Fund have been so useful and, at some critical points, essential. Those resources, I remind you, were provided by Congress some 60 years ago in the aftermath of the great international financial debacle of the early 1930's. They have, in my experience, been used sparingly and prudently. That includes a number of occasions during the Latin American debt crisis of the 1980's. There, the pattern was set of using them in conjunction with other financial authorities and paralleling assistance by the IMF. I have no doubt, along with the so-called swap facilities of the Federal Reserve, the availability of the Exchange Stabilization Fund was essential to containing that earlier crisis and avoiding a systemic breakdown in international banking.

To be sure, present arrangements with respect to Mexico are without precedent in size and nature. But it is also true that those arrangements were only put in place after consultation with and, as I understand it, the acquiescence of bipartisan congressional leadership.

Surely, this Committee is justified in carefully reviewing the approaches taken in this crisis, and achieving full understanding of the precipitating events and the responses to them. What would be inappropriate, as I see it, would be to either attempt micro-management of the use of the ESF, or to so constrict its future use as to render it ineffective in the face of future crises, which, if history tells me anything, are sure to recur.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Mr. Volcker.

Congressman Kemp.

OPENING STATEMENT OF JACK KEMP CO-DIRECTOR, EMPOWER AMERICA; FORMER SECRETARY OF HOUSING AND URBAN DEVELOPMENT, WASHINGTON, DC

Mr. KEMP. Thank you, Mr. Chairman. It is a great pleasure to appear today here in the shadow of the Chairman of the Federal Reserve Board. I had always wanted to have this opportunity.

[Laughter.]

Let me say it is a pleasure to appear with Chairman Volcker and, Mr. Chairman, thank you for your very gracious invitation to testify.

My testimony will be somewhat more provocative than Chairman Volcker's, but I do agree with former Chairman Volcker that we should not micro-manage it if it means destroying or eroding the sovereignty of Mexico.

The question today is: Should we help Mexico?

The answer to that is: Yes.

The real question is: What is it, exactly, we are supposed to do to help Mexico?

My testimony, Mr. Chairman, will be in that vein.

I want to thank you, Mr. Chairman, for holding these hearings and commend you for your insight on this issue and your leadership in not only holding the hearings, but your original very decisive opposition to the $40 billion bailout that the Administration had proposed several weeks ago.

I am not here to attack the Administration. I support NAFTA and GATT. I support the effort to use Exchange Stabilization Fund moneys to, as the Chairman suggested, help Mexico.

The question is: How do we do it in the efficacious and the most positive way?

In my view, Mr. Chairman, if the Administration had accepted the efforts of Majority Leader Bob Dole, Senator Bennett, Senator Mack, and others to develop a truly bipartisan approach to helping Mexico revalue their currency and restore confidence in their economy, we would not be holding this hearing today.

Let me make this unambiguously clear, Mr. Chairman. The damage to Mexico was not caused by some mysterious outside force. It was caused by an explicit policy decision of the Mexican government on the advice of the Treasury Department and international

financial institutions, including the International Monetary Fund (IMF) and the World Bank.

This morning's Washington Post says that:

> U.S. officials indicated that they urged Mexican counterparts, as far back as the Salinas Administration, with increasing vehemence during the last months of the Salinas Administration, to allow the value of the currency (i.e., the peso) to decline relative to the dollar.

It goes on to suggest that is the mainstream approach to modern economic thinking in the world.

I want to suggest here today, Mr. Chairman, it is a disaster. You cannot read the morning paper and not have your heart go out to what's happening to the people of Mexico.

The austerity plan announced today, Mr. Chairman, includes an increase in gasoline prices of 35 percent and an increase in the cost of electricity of 20 percent, with monthly increases for the rest of the year. The VAT tax, which was 10 percent, is going to be increased 50 percent. Increase in the minimum wage will be held down.

Isn't it interesting? The wages of the lowest income workers in Mexico will be held down by government fiat and workers above the minimum wage are free to negotiate higher wages. It is always the worker who gets stuck in a devaluation. It is always the lowest income people, those on fixed wages, earnings, pensions, and savings, who are going to be hurt.

There is absolutely, Mr. Chairman, no plan to stabilize the peso in the austerity package announced this morning from Mexico City.

In my view, Mr. Chairman, fiscal austerity will not be sufficient to solve Mexico's monetary crisis. And, as I suggested, it will further impoverish the worker, impoverish the poor, impoverish the older generation of Mexico, and exacerbate the tensions along our border.

It is no secret that I have always believed a government has both a utilitarian and a moral responsibility to protect and preserve the value of a currency. Since a government has the monopoly power of the issuance of the currency, it therefore has an obligation to preserve its value.

It was best put by Argentina's Minister of Finance, Domingo Cavallo, when he made the statement, "Every peso is a contract between the government and the people, and to devalue a currency is to break that contract, to break that handshake, to break that trust, and, frankly, with the result of breaking the law."

I do not believe there was any need to devalue the peso. One need only look at the results of the devaluation to come to that conclusion.

They are suggesting—and I am using this parenthetically to my statement, Mr. Chairman—they are suggesting that they need to bring the budget into balance by austerity measures, raising taxes on wages, VAT, sales taxes, businesses, and, of course, people of upper income, everybody, in order to bring budget austerity.

Mr. Chairman, they had it before the devaluation. The budget was in balance when they devalued.

As it stands today, Mr. Chairman, there is no end in sight to the decline of the peso. Chairman Volcker just got a report that it is trading between 6.6 and 6.8 to the dollar. It reached 7 yesterday.

The CHAIRMAN. Seven point seven.

Mr. KEMP. There will be no end to the fall of the peso until the governments of both Mexico and the United States reestablish a credible value to the peso, which ultimately must result, in my view, in revaluing the currency to 3.5, or at least 4, to the dollar. It could be phased in.

The Mexican government, in my opinion, Mr. Chairman, is now engaged in a futile attempt to raise interest rates high enough to stop the flight from the peso. I want to say as emphatically as I possibly can: Raising interest rates will not help. It tells us nothing about what is happening with the currency printing presses. The Mexican government, in my opinion, Mr. Chairman, may be able to induce investors to hold short-term bonds, but they will not restore confidence in the peso or convince people that Mexico is a good place to invest for the long term under the current plan.

This devaluation has been a disaster on both sides of the border.

I spoke last weekend with Governor John Engler—Senator Bennett and I spoke with John Engler, the Governor of Michigan. He mentioned that Detroit auto exports are dropping, plummeting because they won't be able to sell them in a country that won't have enough earnings to purchase automobiles produced in Detroit, Buffalo, or in your home State.

Beyond hurting the worker and the saver and the consumers of Mexico, Mr. Chairman, the current crisis is undermining support for NAFTA, the North American Free Trade Agreement. It also undermines the future of all free trade agreements. Free trade, in my opinion, cannot be sustained, Mr. Chairman, under a policy of competitive devaluations and other beggar-thy-neighbor policies supported by the IMF, and apparently supported, as early as last October and before, by the Treasury Department of the United States.

Mr. Chairman, I agree with you, Members of this Committee, and the Republican leadership that we can support the general idea of helping Mexico without supporting the specific idea of using U.S. taxpayer dollars to bail out Mexican creditors.

I opposed the Clinton Administration's original $40 billion in loan guarantees because there was no policy mechanism.

I agree with Chairman Volcker, we do not want to micro-manage. I have seen some suggestions that the Mexican people have to learn Swedish in 6 months in order to get help from the United States, and other similarly ridiculous ideas.

I, on January 24, 1995, called for the resignation of the Chief of the IMF, Michel Camdessus, for the complicity of the IMF in pushing Mexico toward devaluation. I think they should be held accountable, Mr. Chairman, as these hearings, I believe, undoubtedly will prove, for the disastrous policy they prescribed and the devastating economic and social consequences they have caused.

The good news, Mr. Chairman, is that it is not too late to repair the damage that has been done to Mexico.

In my view, the Treasury Department should advise Chairman Greenspan that it wishes him to deploy the ESF moneys, the Exchange Stabilization Fund, solely to purchase pesos on the open market and not purchase debt. It will do absolutely no good, as it has not in the——

The CHAIRMAN. Congressman, let me ask you a question on that point.

Mr. KEMP. OK.

The CHAIRMAN. If you are purchasing pesos on the open market, then does not that also mean that the government printing presses——

Mr. KEMP. Yes.

The CHAIRMAN. —should be stopped from printing pesos?

Mr. KEMP. Absolutely.

The agreement between Chairman Greenspan and the President of the Banco de Mexico, Miguel Mancera, should be that they cannot then sterilize and print pesos as we extinguish. Both sides of this arrangement need to extinguish the supply of pesos to increase the demand of the peso, thus strengthening the peso. Interest rates, in my view, would not go up; they would go down.

I realize this is controversial. Of course it is. I have been controversial before, Mr. Chairman.

[Laughter.]

Chairman Greenspan, as I said, must get the assurance of the Bank of Mexico that the Mexican central bank will not purchase any assets with pesos until the peso/dollar rate is phased back to 4 and, ultimately, 3.5 to the dollar, where it was on December 20, 1994.

This can only be done if the Mexican government stops printing pesos, as you suggested, Mr. Chairman, and instead extinguishes them.

As Treasury Secretary Rubin and Under Secretary Lawrence Summers testify later this morning, I think there are some questions they should be asked. At the risk of being too bold, Mr. Chairman, nah——

[Laughter.]

Nah. Somebody has to say and ask these questions, in my opinion.

The collapse of a currency reflects an excess supply of the currency relative to demand. So, instead of devaluing, I think the question should be asked of the Secretary of the Treasury and the Under Secretary for International Monetary Affairs: Couldn't the Mexican government have maintained confidence in the currency by withdrawing excess pesos from the financial system as any government would do if they have an excess of dollars or pesos relative to the demand?

No. 2, Mr. Chairman, the Treasury–IMF rescue package is an attempt to refinance Mexico's short-term debt. Maybe some of that has to be done. I will not make the judgment that nothing should be done, but, essentially, it is putting U.S. taxpayer funds at risk to buy interest-bearing Mexican assets.

If the value of the peso has shrunk, or will shrink, another 25 percent, half its total decline, in the last 2½ weeks, on what basis can there be any expectation, Mr. Chairman, that this program will succeed without a concerted effort to restore the value of the peso?

No. 3. Instead of using the Exchange Stabilization Fund to buy Mexican bonds, the Fed could be instructed to buy pesos, as I alluded to. The Mexican monetary authority, as you suggested, Mr. Chairman, would agree to extinguish pesos and thus increase the

demand for the peso, bringing down interest rates, not raising them.

I think this morning, correct me if I am wrong, Mr. Chairman, short-term 30-day paper in Mexico is close to 59 percent or higher. It was 13.5 percent when they announced the devaluation, and now it is 50 percent.

I would like to know how it is possible that anybody can suggest that this has been successful.

No. 4, Mr. Chairman. Wouldn't a credible commitment to restoring the value of the peso reduce inflationary expectations, help restore investor confidence, and, as I have suggested here today, actually allow interest rates to fall?

Finally, No. 5, Mr. Chairman. The austerity measures imposed on Mexico as conditions of the Treasury–IMF program appear to be based on the idea that somehow Mexico will be better off if it suffers a major economic contraction, because that is what is coming. I mentioned reduced wages, wage controls on the lowest income people, higher taxes, and VAT taxes. The question is: Aside from direct economic effects, have U.S. officials considered the potential impact on Mexico's social and political stability? Are we prepared for the instability of our border as people are forced to look for work outside of Mexico?

I think the current path, Mr. Chairman, has only produced economic stagnation, devastating inflation, and social unrest. But the course was not inevitable, and I hope that, working together, we can help the Zedillo Administration help put Mexico, NAFTA, and the rest of Latin America on a growth path for the rest of this century.

Thank you very much.

The CHAIRMAN. Thank you, Mr. Secretary.

I do not know whether to call you Mr. Congressman or Mr. Secretary. I like to say "Congressman."

Mr. KEMP. "Old number 15."

[Laughter.]

The CHAIRMAN. Let me say that I think your fifth question or proposition, that the austerity measures imposed on the Mexican people are doing little and will have little impact on Mexico's economic problems, except to exacerbate the social unrest that already exists—people are already paying mortgages at 85 percent interest on their homes and on their businesses.

The fact is that the American people have a right to know exactly how the billions of dollars put forth will be used.

Today, in his testimony, Secretary Rubin mentioned that we are involved in securing some of Mexico's public debt.

Is this really an aid package?

How are these dollars being utilized?

Should we finance and support a corrupt, dictatorial government that has little semblance to democracy as we know it?

We have a myth of a democracy. This is incredible. The rich get richer. The poor, as you have outlined, suffer. And the United States of America, big brother, will be blamed for making available billions of taxpayers' dollars.

Somehow, we should not be saying this. This is like Never-Never Land, the United States and Congress here. We are not supposed

to say publicly what we talk about privately because, somehow, you do not do that.

This is absolutely scandalous. Congress has not received the information we have been requesting about how this situation developed. We have only received parts of that information from Treasury.

And then, not to be micro-managing, but to be advised explicitly how the billions and billions of dollars that we are making available will be utilized, and not to know whether the printing presses of Mexico—I am going to ask the Secretary, how many pesos have been printed since we started this rescue plan?

If, on one hand, we are attempting to stabilize the peso, boost the peso's value, and maybe buy pesos up, then, on the other hand, does it make sense to continue to print them?

What are we doing?

Whose investments are we bailing out?

When people invest in risky financial instruments, such as Tesobonos, that pay 20, 30, or 40 percent, should the United States of America just say, "Well, we are going to come in and rescue you"? Is that the function of the taxpayer?

This Senator has some very real concerns, but it comes basically down to the fact that the American people have the right to know exactly what is taking place. I do not think there is any great mystery that should be shrouded in secrecy. We have a right to know, and I would like to know exactly how much money we have really committed to this project.

Is it $20 billion, is it $30 billion, or, as some suggest, is it $40 billion?

If we have committed $20 billion through the ESF, do we have an obligation to replenish the IMF? That might cost another $10 billion. So have we now committed $30 billion?

How much of the swap money have we extended? Have we pledged more?

I do not know, but the American people certainly have a right to know.

I have shared with you some of my concerns. I know we have another panel and a lot of questions, so I am going to forego the rest of my time.

Senator Sarbanes.

OPENING COMMENTS OF SENATOR PAUL S. SARBANES

Senator SARBANES. Thank you, Mr. Chairman.

Chairman Volcker, I think you ought to address this point that is now being raised. Secretary Kemp asserted that, actually, we should be using the money to hold up the value of the Mexican peso. What is your view of that? What would that lead us to? How much would that cost? How would that play out?

I take it that is not your position.

Mr. VOLCKER. I do not want to speak for Secretary Kemp. I do not think he was suggesting intervening in the exchange markets to stabilize the currency. He was calling for a reduction, I guess, in the creation of pesos or in the creation of the monetary base in Mexico.

I think what we are debating here is a question of—I hate to call it tactics because that sounds like it is a minimal kind of question, it is not a minimal kind of question—how one aims toward what, I take it, is an agreed aim.

I yield to no one in my interest in seeing stability restored in Mexico, and I, frankly, would like to see more fixity in the exchange rate eventually.

The question is how do you get there and how do you move? I think it is unrealistic for Mr. Kemp or others to suggest you can get there, without damage to the Mexican economy, simply by shrinking the supply of money, which I think in the short run would send interest rates even higher.

There is a well-established relationship between the rate of increase or decrease in the money supply and the interest rate, certainly in the short run.

Now, when you establish the conditions for stability of the exchange rate and stability of prices, interest rates ought to go down.

The question is how can you do that most rapidly and with the least damage to the Mexican economy in a very difficult situation?

I think we have a situation here which is rather fundamental to the success of any program, and that is a lack of confidence. A lack of confidence certainly in the Mexican currency, as Secretary Kemp suggests, a lack of confidence in anyone's ability to restabilize that in a hurry. That affects the flow of money into Mexico from private investors, but it affects the behavior of Mexicans, themselves.

I would like to think there is some magic single policy, like reducing the supply of pesos, that is going to restore confidence and stability promptly. I simply do not think that exists. A twisting of the monetary screws, to the point suggested by Secretary Kemp's proposal, seems to me all too likely to create unbearable stresses on the Mexican economy and damage what we would like to see, rather than the reverse.

Mr. KEMP. Could I——

Senator SARBANES. So it would be your view——

Mr. KEMP. Paul, could I have just a short response to your previous question?

Senator SARBANES. Let me just continue with the Chairman.

Mr. KEMP. All right.

Senator SARBANES. And, if time permits, I will certainly be pleased to have you address it.

Mr. KEMP. Thank you.

Senator SARBANES. And, if time doesn't permit, I am sure the Chairman will allow time for you to do so.

[Laughter.]

The CHAIRMAN. I think that is a safe assumption.

Mr. KEMP. Since I am the center of the controversy, I thought it might be appropriate to allow me to respond.

Senator SARBANES. I did not really mean to make you the center of the controversy. I am merely trying to draw Chairman Volcker out on what he thinks is sensible to do in this situation, because we are hearing a lot of ideas about what ought to be done.

I take it, Chairman Volcker, it is your view that the pain to the Mexican economy, about which Secretary Kemp spoke, might in

fact be greater if you pursued a policy of trying to hold up the value of the peso. Is that correct?

Mr. VOLCKER. Again, you say "uphold" the value of the peso.

I want to see, I would like to see the value of the peso stabilized. I would like to see it at as good a rate relative to the dollar as they can reasonably manage and be sustainable.

I do not think that is 3.5 anymore.

Senator SARBANES. Would you use the Exchange Stabilization Fund solely to purchase pesos on the open market?

Mr. VOLCKER. No.

Senator SARBANES. Why not?

Mr. VOLCKER. Because I think that would be premature in achieving the basic objective, or one of the objectives, of stabilizing. If that is all you did, I think you would find yourself pouring money down the spout without having a permanent affect. What is going to matter is the policies in Mexico in the end.

I might point out, just in terms of pain in Mexico, part of the difficulty is, once the confidence is lost, they can no longer finance the kind of current account deficit they were running before. They were running a current account deficit of something like 8 percent of the GNP, if I remember the numbers correctly. That won't be possible under these circumstances. When you suddenly reduce that source of goods and services, 8 percent of the GNP, rather suddenly, you have a difficult adjustment problem, no matter what particular policies you adopt.

Now, part of the reason for the American and IMF assistance is to ease the suddenness of that change.

Senator SARBANES. Secretary Kemp, you wanted to respond?

Mr. KEMP. The fact remains, Mr. Chairman, that the pain is unbearable under the current policy, as Chairman D'Amato pointed out. Ortiz, the finance minister of Mexico, today, as quoted in USA Today, said that there is a very bleak future for Mexico. There is recession, job loss, and hardship for his country.

All of a sudden, we are debating whether or not the pain's going to be greater.

Mexico ran a current account deficit of $25 billion in 1992, $23 billion in 1993, kept the peso at 3.1 to the dollar, and the economy recovered.

This is from Bob Bartley's article in the Wall Street Journal, "Mexico Suffering From the Conventional Wisdom." I would like to put it in the record, Mr. Chairman.

They had a balanced budget, their economy was growing, and inflation was low. All of a sudden, thanks to the IMF and the U.S. Treasury Department officials, we told them to devalue as early as Salinas' last months in office, and we are seeing pain, may I say to my friend from Maryland, pain of unbelievable proportions, and we are suggesting that there is no solution other than to bail out their debt.

I am simply suggesting that we should have an arrangement between the Fed, the United States, and the Banco de Mexico to extinguish pesos to increase the demand for the peso, and in my view—albeit I am certainly at odds with my friend, Chairman Volcker—I think we would find that long-term interest rates would

come down, and that would be bullish and positive for their economy.

Thank you.

The CHAIRMAN. Senator Gramm.

OPENING STATEMENT OF SENATOR PHIL GRAMM

Senator GRAMM. Thank you, Mr. Chairman. Let me make a brief statement before I ask a couple of questions.

It seems to me Mexico's problem is a problem that has been common to their devaluations over the last 40 years, and that is that they have never had an independent monetary authority. What happens is, when the governing party gets under political stress, they turn to the central bank to turn on the printing press.

Now, we do not have very good data on it. One of my frustrations, in trying to be of assistance to Mexico, is that we have never had good access to their monetary data. I still do not understand when it was that the Treasury knew there was an explosion occurring in the monetary base in Mexico. The data we do have indicates that in the first half of 1993, currency and bank reserves were growing at about 3½ percent a year. In the last half of 1993, they were growing at about 6½ percent a year.

Then, in the first half of 1994, the increase in currency and bank reserves exploded to over 20 percent a year. This set off a round of inflation, which occurs quicker in the Mexican economy than it would here, because of the long-term built up expectations about inflation. Business people always keep one ear to the ground to hear the rumbling of a coming inflation and they react quickly.

So, it seems to me what is desperately needed in Mexico is an independent monetary authority, a currency board, or some type of solid base to its currency that would give it stability or would give the world some confidence in its currency, give its people confidence in its currency, by controlling the growth of the monetary base.

I agree with Secretary Kemp. If you believe that the foundation of this problem is the explosion of the money supply, fiscal austerity in and of itself is not going to help, and, in fact, could hurt. It will clearly affect growth.

Mr. KEMP. Yes.

Senator GRAMM. The concern that I have, after listening to the President's explanation of how the injection of American liquidity into Mexico is going to solve the problem, is that I did not hear a concrete proposal about what Mexico was going to do to deal with its own problems. I think this is where my views now conform to both the views of Chairman Volcker and Secretary Kemp. That is, in the end, what we do is not going to be very important. In the end, what Mexico does is going to be very important.

If Mexico does the right things, in the short run we can help them with a liquidity transition and make it easier for them to adjust. If they do the wrong things, there is not any finite amount of money that is going to solve their problem. We will end up losing the $40 billion and they will end up losing their economic prosperity.

I do think the tragedy, as Secretary Kemp pointed out, is that there are a lot of people who think this has something to do with trade, that think this has something to do with NAFTA.

Frankly, this crisis has to do with a country that does not have effective control of its money supply.

In terms of what you have seen in the monetary aggregates, is it your view, Chairman Volcker, that the problem in Mexico is primarily a monetary phenomenon of inflation? Or is it caused by some artificial imbalance in trade relations?

What do you see as having been the failure that let an economy, that was brimming with liquidity at the beginning of 1994, suddenly be broke at the end of 1994? What produced this evaporation of liquidity?

Mr. VOLCKER. Let me say, first of all, Senator Gramm, that, ironically, Mexico has legally an independent central bank. It has been put in the constitution.

Senator GRAMM. I know it has.

Mr. VOLCKER. We should do so much in the United States.

So we cannot, I think, blame it on the lack of legal independence.

The figures that you have on the money supply are not familiar to me, but I will tell you I do not think they have been terribly open at producing figures as time has passed, and that probably was not very helpful in this situation.

I think it is fair to say, in a very complicated situation, that the central bank or the Government of Mexico did not respond, in retrospect, with as strict a monetary policy in 1994 as might have been desirable.

Understand that, in this world, other factors sometimes intrude. They had an assassination of a Presidential candidate, they had a revolt in Chiapas, they had a Presidential election, and they had another assassination following the Presidential election, all of which undermined confidence and may have led the central bank to be somewhat more accommodating in monetary policy than otherwise would have been desirable, if I can put it in such rotund phrases, in retrospect.

But I think the problem is much more complicated than that. The inflation rate in Mexico was going down during this period, not up. By and large, I think monetary policy has been very responsible over a period of years and they were using the exchange rate and the stability of the exchange rate to try to reinforce the anti-inflationary policy. That policy, I think, made some sense for awhile, but is questioned, in hindsight, that maybe it was prolonged too long.

My general explanation would be that Mexico is undergoing a very rapid economic change in a very constructive way. The economy has been opened up and privatized; their market system much more relied upon. Their exports have been doing very well, but have been unable to catch up with the burst of growth and consumption at home.

That left them with a big balance of payments' deficit which eventually undermined confidence in their ability to sustain the currency against the policies that you and I have described in somewhat different terms.

Among other things, while their budget was in balance last year, they were rather rapidly increasing credit through their government development banks. If anything was too easy last year, it was the outpouring of semi-subsidized credit through the development banks, which are not reflected in the money supply, as I understand it. It came through the back door, so to speak.

So it was a complicated process which, I think, in some ways did reflect a fundamental imbalance between their exports and their imports, even though their exports are doing well. And that goes back, in part, to the fact that they have caught the North American disease of lack of savings.

They are not quite as bad as we are in that respect, but they have been moved toward more consumption than they can afford at this time, and I think that, unfortunately, is part of the adjustment.

I might just say one word, if I may, in response to the Chairman's comments in talking about the political problems of Mexico, and they certainly have them.

My sense is, and one of the reasons why it is important to try to ease this adjustment and provide some support, is that the political system has become more open, more reliable, and less corrupt, and it is very much in our interest to foster that development.

The CHAIRMAN. Mr. Chairman? Mr. Chairman, while I respect you as it relates to your expertise in the Fed and monetary policies, as it relates to the judgments in terms of politics, I think I have some experience.

I have to tell you, if we call that a democracy, it is a sham. It has been held out to be a democracy. It works for the rich. It works for the entrenched. By no means do they have one man/one vote. It is a minor miracle when the opposition is allowed and permitted, after they win overwhelmingly, to take office.

Somehow, by the dressing-up of some of the very fine people, and I am not suggesting to you that there may not have been some attempts and some people who are well-educated, who have gone to fine American universities, and who talk about capital systems, but if we are really going to talk about how they can help their economy, let them privatize the oil.

Let's get to it, instead of having every person who leaves high government positions walking away as trillionaires. Just take a look at what is taking place in terms of the assassination, in terms of who is charged with the assassination, and in terms of the Attorney General, Deputy Attorney General, it turns out, with millions of dollars in a bank account. Let's not kid ourselves, that is one of the problems.

It is one thing to make an agreement with a government that is based in democracy, respects the fundamental principles of law, and is going to carry those agreements out, and it is another thing to say we have agreements and conditions that are never going to be implemented.

If you really think it is collateral backing up in terms of the oil revenues, how are you going to get that collateral? Are you going to send the American troops down there?

Do we know if we can get the central bank over there to stop printing pesos?

What are we going to do after we have invested billions of dollars if they start printing pesos again?

I have to tell you, I have a very, very different view, and I was under the illusion that they had attained this democracy and were making great strides. There are some people who have made a lot of money in privatization, but it is not reaching the average Mexican citizen. That is my view of it.

We are well over the time, but I did have some spare time.

Senator Moseley-Braun.

OPENING COMMENTS OF SENATOR CAROL MOSELEY-BRAUN

Senator MOSELEY-BRAUN. Thank you, Mr. Chairman. I was very interested to hear Chairman Volcker talk about the issue of confidence and whether or not the confidence that the market has about the conditions of interest rate stability in Mexico would be able to be, if not restored, then created.

I could not help but think we are talking about a situation like a next-door building burning up while we are sitting here. Argentina is feeling the heat, we are feeling the heat, and all of South America and Brazil are feeling the heat. It threatens to engulf a number of countries.

The President has tried to take out a bucket to at least protect our direct interests. I did not support the plan that was originally put to Congress, but then he came up with the Executive Initiative on his own, and it was at least an effort that recognized our interests in what was going on right next to our borders.

So, the question becomes, what is going to happen here and can we fix it, or can the Mexican government take steps to fix this problem?

Now, Mr. Ortiz came out yesterday with a plan, and I guess my first question would be to Chairman Volcker.

Have you had a chance to take a look at what that plan consists of? If so, do you think that it is adequate?

You talked about the lack of access to monetary—someone talked about the lack of access to monetary data. Is there enough hard information published now to give us some level of assurance that we will be able to achieve some stability here?

Mr. VOLCKER. My total knowledge of that program is what I read in the New York Times coming down on the plane this morning, so I will not pose as an expert, but I do think that the intent is, just on that statistical point, to provide much more information more frequently. The Mexican central bank in the past, it is quite true, has not provided a lot of information regularly and up-to-date.

I do not think that is going to solve their problem. I am afraid that, although publishing the information is interesting, useful, and over time may help to restore confidence, there is nothing in that that is going to solve their immediate problem.

I do think they have taken some measures, as I understand it, that are necessary and pointing in the right direction.

Certainly the tightening of the budget, for all the difficulties that imposes, in this kind of severe situation where interest rates are so high—and that is perhaps the most damaging thing in terms of the domestic Mexican economy at the moment—one way to get relief is to rely a little more on fiscal policy. I think that is clearly

what they are doing. I think that was very much called for and really the heart of these new measures, as I understand them.

There is more attention to monetary policy. While they did not set any targets or say much about the exchange rate, as I understand it, I think they did, according to the article, give prominence to monetary policy and to the necessity to stabilize the exchange rate. I think that is a step forward.

Mr. KEMP. The most transparent thing that is happening, Senator Moseley-Braun, is the collapse of the peso. I do not believe that you can solve a monetary phenomenon with fiscal measures.

Obviously, fiscal policy is important, but they had a balanced budget before they devalued. The people that are making out are the ones that Senator D'Amato alluded to when he suggested that the rich got even richer.

There is an interesting article today in the Wall Street Journal. It says, "Currency Speculators Post Huge Gains Amid Turmoil."

Ask yourself: If you knew a currency was going to be devalued, would you hold it or short it?

How about the people that shorted the peso on the information that the U.S. Government was telling Mexico to devalue the currency, and you hold pesos?

You would borrow pesos, convert to dollars, pay back the peso debt denominated in pesos with——

Mr. VOLCKER. [Showing a newspaper article to Mr. Kemp.]

Mr. KEMP. Yes. Even Paul Volcker has a copy of this article. He didn't just read the New York Times.

[Laughter.]

But they shorted the peso and made huge gains, all at the expense of the poor, the wage earner, the senior citizens, and the economy.

I want to say, once again, I think it is impossible, Senator Moseley-Braun, to think that these fiscal solutions of higher taxes, a higher VAT tax, a 50 percent higher VAT tax, sales taxes, energy prices, gasoline prices—and you didn't hear my original statement, but they put wage controls on the poor and allowed people above the minimum wage to negotiate higher wages. So, in effect, this is—excuse the expression—1972 redux.

Mr. VOLCKER. Let me, if I may, suggest that we have an interesting experiment going on in Latin America, and maybe elsewhere.

Argentina, which has a much less severe adjustment problem, as I understand it, than Mexico, a smaller balance of payments' deficit, and essential price stability, or very close to price stability by Argentine standards, has been operating what is called a currency board system. It is also under great strain and interest rates there, overnight interest rates, have gone up to something like 50 percent as well, without the additional complications that Mexico has had. They are struggling to maintain banking and financial stability in that country, operating a currency board system.

Now, it seems to me, the implication of what you are saying about the way Mexico should be operating their monetary policy, and given the weakness of the dollar in recent days, you must be calling upon the Federal Reserve to contract the monetary base and the money supply in the United States right now to maintain stability of the dollar.

Mr. KEMP. No.

Mr. VOLCKER. Is that the appropriate—no, it is not?

Mr. KEMP. No, it is not, because we do not know what the dollar is doing against the yen, because we do not know what reference point you are using. If the yen is appreciating, the dollar would fall relative to the yen.

I believe that the Bank of Japan is too tight, and I think I would make a case that the Central Bank of Germany is too tight.

You do not know—what is your reference point?

If the dollar is stable against the price of gold, I would be more concerned about the yen and the Deutschemark tightening.

The CHAIRMAN. At this point, I am going to thank our panel.

Mr. KEMP. Let me——

Senator MACK. You shouldn't have stopped that. This is historical.

Mr. KEMP. You are missing an historic clutch.

The CHAIRMAN. We have it down on film.

[Laughter.]

Let me suggest to Senator Shelby, who is next, Senator Mack, and right on down the line—of course, any of the Senators who want to pose questions now can take their time to do so—that we ask the next panel, Secretary Rubin, to appear, and then start the questioning with Senator Shelby.

If any Senators want to use their time now, that's fine, but if not, I would suggest that, instead of starting from the beginning, we begin where we left off. This will give our Members a better opportunity to ask questions sooner.

It is up——

Senator Shelby.

Senator SHELBY. Whatever you want to do, Mr. Chairman. If you want to expedite the——

The CHAIRMAN. I think this way we would get to the Secretaries, and I want to thank the panel.

Senator MACK. Mr. Chairman, really——

The CHAIRMAN. Yes? If any——

Senator MACK. I do have a question.

The CHAIRMAN. Fine.

Senator MACK. And I apologize.

The CHAIRMAN. No, no, no, no. If you want to use your time now, that's fine. Otherwise, if Senator Shelby wants to pass, I would recognize him first in the next round.

Go ahead, Senator.

Senator Mack.

OPENING COMMENTS OF SENATOR CONNIE MACK

Senator MACK. I want to ask Chairman Volcker: You indicated, and I agree with you, that the United States is important and influential, and that we should help Mexico. I am reminded, though, at least as I look at it, that you faced a similar problem in the late 1970's and early 1980's. The dollar was weak, inflation was high, and it looks as if—again, as I look back on this—there was a tightening of monetary policy, a cutting of taxes, and a slowing of the growth in government, which is just the opposite of what people seem to be suggesting should be done in Mexico.

How do you match those two points that I have made?

Mr. VOLCKER. I do not think it is the opposite of what we are suggesting to Mexico.

Our monetary policy was rather restrictive then, and interest rates were very high, and, unfortunately, we did go through a big recession. I think, at the end of the day, as we got more stability, obviously, interest rates came down and the economy expanded, and we had the longest period of growth that we have ever had in this country, if I recall the figures correctly.

Senator MACK. Right, we cut taxes.

Mr. VOLCKER. But we went through that difficult adjustment period to get it started.

We did have a tax reduction, and there is a great debate. Congress took some of it back a couple of years later and we still had a big deficit. There was a question, and I won't answer that debate today, as to whether that was helpful or harmful in the speed of the adjustment that was made in the early 1980's.

Senator MACK. But the point is, Mexico is not following a tight money policy. In fact, I think what is being proposed is that they can allow their money supply to grow at something less than what the inflation rate is. That does not sound to me like it's a tightening of monetary policy.

Mr. VOLCKER. It is a matter of degree. Money supply increasing less rapidly than the rate of inflation is often an indication of a relatively tight money supply. It is a policy that ought to bring the inflation rate down.

Senator MACK. Let me be specific then.

Are you saying that you think it is good for the Mexican economy, if inflation is going to be, according to what they are now projecting, somewhere between 48 and 50 percent——

Mr. VOLCKER. I think it is terrible.

Senator MACK. —that they allow their monetary base to grow by 40 percent?

Mr. VOLCKER. I do not know enough about it to know exactly what the number is, but I think it cannot grow by zero without provoking a very large adjustment, and it is a matter of degree.

Our money supply was going up during that earlier period too, that period you were referring to. I happily am not running the Central Bank of Mexico, so I cannot answer your question with any precision.

Senator MACK. Secretary Kemp, do you think you can restore the confidence and increase investment in Mexico by increasing taxes and controlling prices?

Mr. KEMP. Now, Senator Mack——

[Laughter.]

I think this is a tragedy, as I said earlier, Connie. And raising taxes is not the response that you, I, or anybody on the center right of the aisle would suggest. It is ridiculous.

They should be cutting tax rates, reducing the burden of government on the private sector, taking Senator D'Amato's advice, and privatizing, but, clearly, they must extinguish the amount of pesos in circulation to increase the demand for the currency because, as I told Senator Moseley-Braun, the transparency of what is happening today is, people are dumping pesos for dollars and shorting the

peso, and you have to stop speculation. The only way to do that is to increase the demand for the currency.

Short of that, I do not see how they are going to get out of this mess.

I want to say, one more time, Senator D'Amato, Mr. Chairman, I want to help Mexico. I think it is in the interest of the United States to help Mexico. We should praise President Zedillo for taking steps in recent days to crack down.

He said he would crack down on any member of any party, including his own, who is engaged in trafficking or in criminal activity. That is a courageous statement. He arrested the brother of the former President.

There was a recent election, Senator D'Amato, in defense of Mexico, and in their attempts to bring perhaps not Jeffersonian democracy but democratic reforms, the Pon party, as I understand it, won big elections in Mexico recently. I think we should be very careful before we just suggest that we cannot help them unless they become a Jeffersonian democratic experiment overnight.

Senator MACK. Chairman Volcker, I have just one other question. It sounded like, in your response to Senator Gramm's question, NAFTA did play a role in this problem; that the imports to Mexico increased. Exports did not. Therefore, there was an increasing problem in the balance of payments?

Mr. VOLCKER. Their exports increased a great deal. Unfortunately, their exports increased a great deal from a much lower base than their imports. So, despite the rapid increase in exports, they could not catch up because their consumption was pretty high too, and their investment was high.

I think the overall structural implications of NAFTA are favorable. I do not think these trends were importantly influenced by any change made in NAFTA. All those changes resulting from NAFTA take place over a period of time, except to the extent that the climate of confidence, which may have been engendered by NAFTA—you ordinarily think of it as a good thing—may have led to more exuberance in Mexican spending than was otherwise the case. If that was true, it should have been countered more effectively by monetary and fiscal policy. The basic problem is not NAFTA. I do not want to suggest that in any way.

Mr. KEMP. I agree with the Chairman on that, but every developing country runs a trade deficit. As you begin to develop your economy, Third World countries grow and they consume.

What was the purpose of NAFTA if it was not to allow the Mexican people to enjoy the benefits of being able to purchase goods, services, and products from the United States and vice versa?

So they ran a trade deficit. The United States ran a trade deficit in the 19th century. South Korea runs a trade deficit. Japan ran a trade deficit. Third World countries that grow and develop run trade deficits.

The balance to the trade deficit is the investment flows that were coming into Mexico to finance that deficit. To suggest that caused the devaluation staggers the imagination.

I want to identify myself with those who believe that conventional wisdom is hurting not only Mexico but Argentina, Brazil, and Latin America because they fear now a devaluation, to answer

the Chairman, and probably a lot more things before this is done in the global economy.

Thank you, Mr. Chairman, for your courtesy.

The CHAIRMAN. Thank you.

I will ask the rest of the Members, Senator Bond, you would be next, if you wish to ask this panel questions, that's fine. Otherwise, you would be recognized second if you want to start with the Secretary and the third panel. It is up to you.

Senator BOND. I will pass.

The CHAIRMAN. Senator Faircloth?

Senator FAIRCLOTH. I will pass.

The CHAIRMAN. Senator Bennett?

Senator BENNETT. I will wait for the Secretary.

The CHAIRMAN. Senator Grams?

Senator GRAMS. I will pass.

The CHAIRMAN. Senator Frist?

Senator FRIST. I will pass. Thank you.

The CHAIRMAN. Are there any other questions of my colleagues?

Senator SARBANES. Yes. I would like to ask Chairman Volcker: Chairman Greenspan stated in response to a question for the record at a hearing that was held in February:

> By December, given the policies that have been implemented in Mexico and the consequences of those policies in terms of lost reserves and increased short-term dollar index debt, the Mexican authorities probably had no realistic alternative to allowing the peso to float.

Do you agree with that?

Mr. VOLCKER. I think, by that time, that is my impression, they had no realistic alternative to either allowing the peso to float or to devalue.

Now, I think the argument could be, with better coordinated, more forceful policies at that time, there might have been a better chance of preventing this cumulative deterioration that we have seen since then.

Senator SARBANES. Everyone keeps sliding off of the point. It is always, if this had been done, things would have been different.

Obviously, but we have to confront the situation as we find it. You may be able to go back and say, "Well, you should have done things in a different way at an earlier time," but I am trying to search for what we do in the situation in which we find ourselves.

As far as that is concerned, do you think Chairman Greenspan was right when he said Mexico had no realistic alternative to allowing the peso to float, at that time? This is by December.

Mr. VOLCKER. I do not know whether he is talking, whether that statement was before or after the first devaluation. I am saying I think they had no realistic alternative to changing the exchange rate.

I do not know whether I can say they had no realistic alternative other than to float. That is dependent upon too many other things.

Senator SARBANES. He was specifically asked whether, by December 20, when Mexico devalued the peso, they had any alternative. That was the question, and the reply he gave was the reply I quoted to you.

Mr. VOLCKER. With regards to devaluing, I think they had no realistic alternative, at that point, to doing something about the exchange rate.

Senator SARBANES. Do you disagree with that, Secretary Kemp?

Mr. KEMP. Senator, as reported in the Washington Post this morning, the United States Treasury Department has been, with vehemence, urging Mexico to devalue in the latter months of the Salinas Administration.

Senator SARBANES. No, no——

Mr. KEMP. Let me make the point.

Senator SARBANES. —you're going back to earlier times. We have to try to get some fixed reference point in terms——

Mr. KEMP. Let me at least answer the question.

Senator SARBANES. —of doing an analysis.

Mr. KEMP. You cannot analyze the future, in my opinion, unless you analyze the fact that the reason people dumped pesos for dollars was because they knew that a devaluation was coming.

If you are sitting on peso-denominated assets, and you hear speculation that the peso is going to be devalued, as is the fear in Argentina, parallel to that in Mexico 3 months ago, you would dump pesos.

That gets a run on the dollar-denominated reserves of the Mexican central bank. Frankly, that, in my view, is what led to this decision. It did not have to be done in the sense that, had they tightened up at that time, Senator Sarbanes——

Senator SARBANES. Which time?

Mr. KEMP. At the time of the loss of foreign reserves. That was a signal to the Central Bank of Mexico to tighten, not loosen.

Senator SARBANES. You mean earlier in the year?

Mr. KEMP. You can take it up until December. On December 20 and 21, 1994, when this became an explicit devaluation, it is my opinion——

Senator SARBANES. Do you think they had an alternative at that point?

Mr. KEMP. The alternative was to tighten, yes.

When money is flowing out of your country, you tighten. When it is flowing in, you can ease, depending upon, of course, the circumstances.

Senator SARBANES. So you do not agree with this? You think they did have an alternative at that point?

Mr. KEMP. That has been my whole testimony, Senator, that there was an alternative. It is to extinguish——

Senator SARBANES. No, at that point in time? I am trying to find out, just to get fixed reference points, whether, at that point in time, you think there was an alternative?

Mr. KEMP. Yes. Yes.

Senator SARBANES. I understand you are arguing that, earlier in time——

Mr. KEMP. No, I am arguing——

Senator SARBANES. —different things could have been done.

Mr. KEMP. Yes.

Senator SARBANES. I am trying to find out whether, at that point in time, you think there was an alternative?

Mr. KEMP. I do, Senator.

Senator SARBANES. OK.

Mr. KEMP. My point is, clearly, that we should have been extinguishing pesos, not printing pesos; increasing the demand for the peso.

People forget it is not only the supply of a currency, it is the demand for the currency. When you hear all this speculation about devaluation, it reduces the demand for the currency. No matter what the supply of money is relative to the demand, if the demand has fallen, you are going to get a collapse, and, thus, they devalued. I think that was a terrible decision urged on them by the IMF and the Treasury Department of the United States of America.

Thank you.

The CHAIRMAN. I want to thank the panel, Chairman Volcker and Secretary Kemp. Thank you.

We'll call our second panel.

[Pause.]

It is good to see you. Why don't we start off with you, and then turn to the Secretary.

Chairman Greenspan.

OPENING STATEMENT OF ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, WASHINGTON, DC

Chairman GREENSPAN. Thank you very much, Mr. Chairman. I am pleased to appear before this Committee to discuss——

Senator SARBANES. Mr. Chairman, it would help if you could pull the microphone closer to you. I know when you put the paper in front of you, you tend to get the microphone away from you, and then it becomes a little more difficult to hear you.

Chairman GREENSPAN. I understand the problem and I apologize, and will endeavor to rectify it, but probably will fail in the process.

[Laughter.]

Mr. Chairman, as you know, I have no prepared statement. However, I am prepared to make a few introductory remarks.

Because of the regrettable delays in implementing effective policies, Mexico's problems have grown larger since I last appeared before this Committee to discuss Mexico on January 31, 1995.

The major implication is that the necessary policy actions by the government of Mexico now also have to be stronger if confidence is to be restored to the Mexican economy and financial system.

However, the burdens on Mexico will be reduced somewhat if it can borrow resources provided by the United States, primarily through the Exchange Stabilization Fund of the U.S. Treasury, and by the international financial community, primarily through the International Monetary Fund. I have characterized this approach in the past, and I repeat it this morning, as the least-worst of the various alternatives that currently confront us.

Mexico, which had been hobbled for a number of years following the debt crisis of 1982, has more recently gone through a major economic metamorphosis toward significant improvement in its economic and financial structure.

As a consequence, Mexico has been able to broaden its participation in the global economic and financial environment. Over th

past decade, Mexico has made major strides. It has shed what was an inflation-prone, highly unstable economic structure with excessive government involvement, and until recently, has taken on many of the characteristics of a vibrant economy.

As part of efforts to accelerate its move toward status as an industrial country, and in the largely successful endeavor to bring down the rate of inflation, the government of Mexico adopted a complex exchange rate regime through which the Mexican peso was linked to the U.S. dollar via a moving exchange rate band.

However, the exchange rate policy adopted by Mexico was risky, and with little tolerance for policy error or capacity to absorb any type of shocks.

As 1994 progressed, private foreign investment inflows slowed for reasons we have discussed many times in the past. Mexican authorities evidently believed, or fervently hoped, that the reduction in foreign investor interest was temporary and that after the uncertainty of the August election was behind them, confidence and private capital inflows would reemerge.

Meanwhile, it became increasingly clear to many observers during the autumn that the prevailing level of Mexico's exchange rate could not be sustained short of a significant further tightening of monetary policy.

Mexican authorities apparently were loath to risk recession, which might have been the consequences of such action, hoping instead for a spontaneous return of foreign confidence and capital. They were tragically mistaken.

The chosen alternative to dramatically tightened monetary policy—that is, borrowing via Tesobonos and drawing on reserves to intervene in the foreign exchange market—had a limit. That limit was reached on December 20, 1994, and the defense of the peso came to an abrupt end.

The reason for that date is that is when they just about ran out of dollars, and as a consequence, had no resources in fact to sustain exchange rates at that particular point.

To address the potentially contagious situation that subsequently developed, the President and the bipartisan leadership of Congress have decided to assist Mexico in dealing with its liquidity problems through a program that would ensure potential access to substantial amounts of medium-term funds from the Exchange Stabilization Fund and the International Monetary Fund.

The objective of this program is to halt the erosion in Mexico's financing capabilities before it has dramatic impacts far beyond those already evident around the world.

To repeat, this program, in my judgment, is the least-worst of the various initiatives which present themselves as possible solutions to a very unsettling international financial problem.

My concern is not so much with the potential losses to the American taxpayer, which I believe have been minimized, but with what economists call moral hazard, where the active involvement of an external guarantor distorts the incentives perceived by investors.

Nonetheless, I currently see no viable alternative to the type of program that is being pursued.

Mexico's economic policies are the key to ensuring that the funds being provided under this program actually do help to stabilize the

Mexican economic and financial situation. Ultimately, only sound policies that are sustained over time will restore investors' confidence in Mexico. Under this program, Mexico is being provided with liquidity so that its government has time to implement fundamental actions to deal effectively with the implications of the inflation bubble associated with the peso's depreciation. It is essential that the bubble be rapidly diffused if stability is to be restored to the Mexican economic and financial system within a reasonable period of time.

Unless Mexico's efforts to restore economic stability and financial market confidence succeed, years of economic reforms in Mexico would be threatened by pressures to reimpose controls in many areas of its economy and to reestablish government interference in what, until recently, was Mexico's increasingly vibrant private sector.

This would be a tragic setback, not only for Mexico, but for the United States and the rest of the world as well.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Chairman.

Secretary Rubin.

OPENING STATEMENT OF ROBERT E. RUBIN, SECRETARY, U.S. DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Secretary RUBIN. Thank you, Mr. Chairman.

Mr. Chairman and Members of the Committee, we greatly welcome the opportunity to discuss with you the United States' response to the situation in Mexico, and we very much welcome your on-going oversight functions. We would like to be as responsive as possible to those functions in the days, weeks, and months ahead.

What I would like to do is summarize events leading up to President Clinton's decision to utilize the Exchange Stabilization Fund, in concert with the broader international effort to assist Mexico at a time of economic distress. But before going into some of the details, there are several points I would like to make and emphasize.

First, President Clinton acted to avert a crisis. There was, and has been, only one criterion in all of our activities: To protect our national interests, protect jobs, protect our standard of living, protect our national security, and protect against surges in illegal immigration. These dangers to our interests reached beyond Mexico with the potential for spill-over effects in other developing countries around the world where we have strong economic interests and strong national security interests.

Second, there is absolutely no question that the President acted within his full legal authority in using the Exchange Stabilization Fund. In that regard, we have legal opinion from the General Counsel at Treasury and separate legal opinion from the Office of Legal Counsel at the Justice Department. Moreover, there is absolutely no impact on the ability or capability of the Exchange Stabilization Fund with respect to protecting the dollar.

Third, while Mexico has been through a period of political and economic difficulty in the past 14 months, it has committed itself to a stringent set of monetary and fiscal policies designed to restore confidence and enable Mexico to recover. Since we signed our agreements with Mexico, it has demonstrated its ability to tighten

further, as by the strong fiscal and monetary steps announced last night, and by adjusting policies to raise short-term interest rates by 20 percentage points in the last couple of weeks. I would point out, as an aside, that since the beginning of this year, Mexico has brought down its outstanding Tesobonos—the short-term debt securities which are, in part, at the heart of this problem—from $29.5 billion to $17.8 billion.

Fourth, the United States committed, "committed," to fulfilling this program when we signed the agreements of February 21, 1995. This program was announced by the President on January 31, 1995, and endorsed by the bipartisan congressional leadership on that day. The program was then underway. Some $2 billion in short-term swaps outstanding from the earlier short-term arrangement will remain outstanding as short-term loans. Since the commitment made on February 21, 1995, by the United States, Mexico has done everything required of it. Yesterday, to fulfill our commitment, we approved the disbursement of $3 billion under the package of medium-term support. At the same time yesterday, the World Bank and the International Development Bank—and this is a new development and we think a very important one—announced they intend to provide $2.25 billion, two and a quarter billion dollars, to help stabilize and strengthen Mexico's banking system, along with technical assistance, and $1 billion to support social sector programs. Last night, the Mexican Cabinet approved the additional fiscal and monetary measures announced in today's press, and today, President Zedillo will speak to his nation on this critical economic program.

Fifth, Treasury and Federal Reserve officials during 1994 communicated to Mexican authorities the belief that its policies were unsustainable. There were private sector parties who expressed the same view in the public domain. There is no secret that the policies pursued by Mexico were, in the final analysis, likely to be unsustainable. On the other hand, many in the private sector shared the conviction with the Mexicans that Mexico could enjoy a resumption of capital flows without significant policy adjustments. In other words, there were significant and substantial differences of opinion in the private sector. Even pessimistic observers who saw the Mexican situation as unsustainable did not expect the crisis that would bring Mexico to the brink of default. I think we are now at a critically important point to understand. There have been many instances in which countries devalued their currency, including quite a number in Europe in the early 1990's, due to unsustainable fixed exchange rate policies. In those situations, markets almost always coalesced around the new exchange rates once the devaluation had taken place. As I say, this occurred in a number of European countries in the early 1990's. The probability of crisis is always very low and crisis is foreseen by few, if any.

As a sovereign nation, Mexico made its own decisions. The choices they made along the way in 1994 were unfortunate in the area of financial policy, but they have been made and Mexico now must live with the very difficult consequences. And the United States, because of the critical stake we have in a successful resolution of this problem, because of our self-interests, has acted as it

has. I have said before, and I will repeat here today, that the risk of failing to act was far greater than the risk of acting.

Having said that, the President first pursued, as you know, a $40 billion legislative package to assist Mexico. Then came a day, a Monday, when the peso reached a then-record low and default looked like it would be likely to occur in a matter of days. At the same time, it became clear from congressional leaders that Congress could not, and would not, act within the required time frame. The President rightly concluded we only had two choices. We could use the Exchange Stabilization Fund or do nothing, and doing nothing involved a high probability of default within a matter of days.

On January 31, 1995, President Clinton, with the support of the bipartisan congressional leadership and an acknowledgement of the legal authority to use the Exchange Stabilization Fund, announced a decision to utilize the ESF to support Mexico's recovery. Three weeks later, I and other U.S. officials and our counterparts signed four carefully negotiated agreements implementing the United States' portion of the Mexican recovery program. Our assistance is designed to support Mexico in its tough and rigorous program to restore confidence in Mexico. It is built upon the program entered into with the International Monetary Fund.

Let me now discuss a few details of the agreements we signed.

The four documents consist of: A framework agreement covering the entire support package; an annex setting out that Mexico's obligations to the United States are backed through proceeds from the exports of oil, oil products, and petrochemicals; an agreement covering medium-term swaps; and an agreement setting out the terms under which we are guaranteeing Mexico's securities. The support we are making available will be disbursed—providing Mexico is meeting its economic policy goals on a tranched basis, that is, step by step—over the next year or year and a half.

Mexico developed a financial plan that will utilize our support to restructure short-term debt into longer-term obligations and assist in maintaining banking system liquidity, a critical factor in the program to bring Mexico back to economic health. If the funds are used to help support the banking system, the shareholders of the banks will likely lose some or all of their investment, while depositors will be protected. In two cases, already stockholders have lost all of their shares and all of the value of their shareholdings in the intervention in banks to protect depositors. The $3 billion in assistance now being distributed or disbursed, however, will be used solely to deal with public sector debt.

The support will be in three forms: Short-term swaps for dollars; medium-term swaps for up to 5 years; and securities guarantees on government obligations up to 10 years.

We will charge Mexico interest rates and fees that are substantially higher than what the U.S. Government calculates is the level of risk we will bear. Our arrangement is structured to encourage Mexico to return to private sources as rapidly as possible. The more they borrow from us, the more it is going to cost them under the schedule of fees that are involved in this set of agreements. That is a substantial incentive to get back to the private market as quickly as possible.

Let me comment just briefly on the financial plan Mexico will pursue. Our agreements with Mexico start from the base of the IMF economic stabilization program, and we built upon that. Mexico must meet strict targets, such as cutting spending, running a budget surplus, and tightening credit to shrink the real money supply. In addition, they have agreed to cut back development bank lending, accelerate structural reforms, accelerate privatization, and provide timely transparency. Let me say once again, the stringent measures announced last night by the Cabinet, and those stringent measures which will once again be discussed with the nation today by President Zedillo, are a major step forward, and we should recognize the political courage involved in taking those steps. By way of example, the fiscal measures Mexico announced last night will yield a 1.5 percent of gross domestic product effect on the deficit. A measure of similar magnitude in this country would equate to $90 billion and, as you well know, that is a very, very substantial undertaking.

It is fair to ask how we will measure Mexico's performance. We took extraordinary steps to ensure that we can see what Mexico is doing, to look at the books early and often. Mexico will begin publishing next week, on a weekly basis, the balance sheets of the central bank. The agreements ensure that Mexico will provide us all, and I repeat all, the information necessary to determine how the Mexican economy is faring and whether Mexico is meeting its obligations. If we need more data, Mexico is obligated to provide it. And, as I noted in my letter to the Chairman Tuesday, the Administration is committed to sharing with Congress, in a timely fashion, the information Congress needs to assess progress in Mexico and to monitor the agreements.

Second—and this is a key point—we are disbursing our support in stages. There is strong conditionality. We must be satisfied that Mexico is making progress and meeting the terms of the agreements before we will provide any installment of assistance. They must tell us how they plan to use the funds involved in each tranche.

There are three other important points I would like to make before concluding. First, the responsibility for success clearly lies with Mexico. They have developed a stringent economic plan, and we have conditioned our support upon their performance. Second, as I just mentioned, we have fully adequate transparency and monitoring. And, third, we have an assured means of repayment in the oil facility. Pemex, the state-owned oil company, has issued instructions to its foreign customers, and these instructions have now been issued, to make payments from the export of oil, oil products, and petrochemicals through the Federal Reserve Bank of New York, and these payments will automatically, automatically, go to our account in the event of a default.

We negotiated carefully, Mr. Chairman, and in a very businesslike fashion. There has been only one criterion in all of our actions, both in the reasons why we moved forward with this program and in all of our negotiations with respect to the terms of this agreement, and that is American self-interests. The President, with the support of the bipartisan congressional leadership, has acted coura-

geously in the face of a crisis that significantly and critically affects our interests.

The agreements we have reached can assist Mexico in regaining economic stability, and prevent the crisis of a default.

There is full legal authority to use the Exchange Stabilization Fund, and, as I said a moment ago, nothing in the agreements in any way affects our ability to protect the dollar.

Let me also emphasize that the key, the absolute key, to our support working is the restoration of market confidence. As I pointed out, Mr. Chairman, in my letter to you last Tuesday, we welcome oversight by Congress. We will work with you in every way possible to make sure that you are fully informed.

We recognize there are substantial differences of view with respect to philosophy and policy. The only thing we ask is that Members of Congress avoid efforts that affect the implementation of this program because those efforts could damage market confidence in Mexico and in the program working, and thereby reduce the prospects of success. This program is sound, and it must be given an opportunity to work.

It was the right decision and, let me add, we must understand, the situation in Mexico is a fact, no matter how much some people might wish its existence away, we share a 2,000-mile border with Mexico. Vital economic and national security interests of ours are very much dependent upon a strong and stable Mexico.

We and Mexico's government fully recognize the circumstances are difficult. But I believe this is a sound program and that given the appropriate opportunity, it can succeed. It will not be an overnight process, it will take patience.

Mr. Chairman, thank you.

The CHAIRMAN. Thank you, Mr. Secretary.

Mr. Summers.

OPENING STATEMENT OF LAWRENCE H. SUMMERS UNDER SECRETARY OF THE TREASURY FOR INTERNATIONAL AFFAIRS, WASHINGTON, DC

Mr. SUMMERS. Thank you.

Mr. Chairman and Members of the Committee, I would like to use this opportunity to describe the events and circumstances that brought Mexico to the present situation, to outline the choices Mexico faced, and to explain the role the U.S. Government played in the events that unfolded last year.

Throughout 1993 and 1994, the Treasury and the Federal Reserve were actively engaged in watching developments in Mexico. Secretary Bentsen had made one of his priorities in the international area the importance of moving beyond consultations with industrial nations, toward greater involvement with emerging markets. He initiated a more intensive exchange with Latin American finance officials. He launched the APEC finance minister's dialog, of which Mexico is a member, and at its first meeting focused attention on the policy issues posed by capital market liberalization and the management of large capital inflows.

In this context, the Secretary and his Treasury staff placed great emphasis on Mexico. Federal Reserve and Treasury staff both closely monitored Mexico's situation throughout last year, and were

in close contact with each other as well as with Mexican officials. As the year went on, Secretary Bentsen, officials at the Treasury, and Federal Reserve officials communicated repeated warnings to Mexican officials at varying levels that Mexican policy could be unsustainable. These warnings took on an even greater urgency as the year progressed. The policies Mexico pursued, however, were Mexico's, and the choices Mexico made were Mexico's to make.

Let me say a little bit in reviewing the economic events of the past 15 months.

Mexico began 1994 with very strong economic fundamentals, after 6 years of solid economic management and sweeping reform.

Nearly 1,000 state-held industries had been sold off.

Tariffs and quantitative restrictions had been slashed back, as had barriers to foreign investment.

The government had transformed a budget deficit of 13 percent of GDP into a nearly balanced budget, the equivalent of five Gramm-Rudmans.

The dollar value of annual Mexican exports had nearly doubled.

Real annual GDP growth had averaged 3 percent over the 5 years to 1994, compared with a tenth of a percent earlier.

Inflation had declined from over 150 percent to 8 percent.

And, in recognition of these accomplishments, Mexico had been the first developing country outside of Europe to be invited to join the OECD.

This exceptional record of economic performance had won the confidence of foreign investors. To be sure, Mexico had a large current account deficit, but going into 1994 Mexico was attracting enough investment to fund this deficit. Most investors viewed the deficit as sustainable, as it was being used to finance private capital inflows which were apparently being used to finance investments. In fact, the level of foreign portfolio and direct investment reached $33.5 billion in 1993, and was sufficiently high in early 1994 to force the Mexican authorities to intervene in the foreign exchange market to prevent the peso from appreciating beyond the upper limit of the exchange rate band.

Mexico had experienced some disruption of capital inflows in November during the U.S. debate over the adoption of NAFTA. The United States, in cooperation with a group of other countries acting through the Bank for International Settlements, put in place a contingency short-term financing facility. The facility was not needed, and flows resumed quickly once NAFTA was adopted. That experience became the prism through which Mexican authorities would come to view disruptions in capital flows throughout 1994.

Recognizing the importance of monitoring exchange rate fluctuations in the context of an expanding trade relationship, in late 1993 Treasury and Federal Reserve officials began considering the establishment of a standing consultation mechanism with Canadian and Mexican monetary authorities on macroeconomic policy issues. In this context, U.S. officials, in conjunction with Canadian authorities, also initiated consideration of enlarging the standing short-term swap facility we had in place with Mexico over the last 50 years.

This contingency planning provided the basis for the Treasury's and the Federal Reserve's quick response to the assassination of

Mexican Presidential candidate Colosio on March 23, 1994, which prompted a sharp decline in Mexican financial markets and a fall in the peso. At the request of the Mexican authorities, we put in place a temporary $6 billion swap facility to counter exchange market pressures associated with the resulting political uncertainty.

Later that spring, we established the North American Financial Group and, in conjunction with Canadian authorities, made the temporary swap facility a standing arrangement. It is worth recalling that, prior to concluding the swap facility, we sought an assessment by the International Monetary Fund of Mexican economic policies. On that occasion the IMF provided a strong and unqualified endorsement of Mexico's economic management.

As part of the new consultation mechanism, Federal Reserve officials were now in weekly touch with their Mexican and Canadian counterparts. Secretary Bentsen and Treasury staff maintained close contacts with their counterparts at the Mexican Ministry of Finance.

The Mexicans understood that the swap mechanism was to be used only to counter short-term financial instability. It would not be used to bolster the exchange rate or be based on macroeconomic policies which proved to be unsustainable.

Mexico's experience during the NAFTA debate shaped Mexican authorities' evaluation of the reserve losses and exchange rate pressures which followed in the wake of the Colosio assassination. While they did increase interest rates substantially in March and April, Mexican authorities expected capital flows to strengthen once market instability faded, as had occurred after the NAFTA episode. On the basis of that assumption, Mexican officials later in 1994 chose to sterilize the effects of foreign reserve losses on monetary conditions.

The government also increased its reliance on borrowing through Tesobonos, which are dollar-indexed short-term securities. These securities' link to the dollar apparently was designed to reassure investors that Mexico did not intend to devalue, and that their currency risk was minimal. In retrospect, however, this increased reliance on short-term dollar-linked obligations helped to bring on Mexico's present liquidity difficulties.

At this point, in the late spring or early summer, a lively debate about Mexican policies was underway in financial and academic circles. A solid number of market and economic observers continued to believe that Mexico's current account and macroeconomic policies were sustainable, and that capital flows would resume once the political situation stabilized. These views tended to prevail over the concerns expressed by some private analysts, as well as those expressed by U.S. officials, about the increased risks Mexico was facing.

Nonetheless, by early summer U.S. officials' concern about the size of Mexico's current account deficit, and the sustainability of Mexico's underlying macroeconomic policies, had become more serious. The rise in Mexican interest rates as well as Mexico's financial innovations had not succeeded in lifting the country's foreign currency reserves back to the levels at which they had stood before the Colosio assassination. As has been subsequently revealed, Mexican authorities over the summer asked the Treasury and the Federal

Reserve to help arrange a supplemental $6 billion contingent credit line from other countries that could be used in the event of political uncertainty. Treasury and Federal Reserve officials perceived increased risks in Mexico's policy course, and communicated these concerns to the Mexicans. These risks involved Mexico's attempt to maintain a fixed exchange rate in the face of a current account deficit that foreign investors were increasingly reluctant to finance without changes in Mexican economic policies that would have made Mexican financial assets more attractive.

At this stage, Mexico still had a range of policy options it could have pursued to remedy the situation. Sharply higher interest rates could have been used to make Mexico more attractive for capital. Accelerated privatization would have increased the demand for pesos, bolstering the exchange rate while raising competitiveness and efficiency. Some modification in Mexico's exchange rate mechanism could have been pursued, likely without major disruptive effects.

Unfortunately, despite U.S. warnings and a continued absence of resurgent capital flows, Mexico did not make substantial policy adjustments. The Mexicans believed it was unreasonable to judge the sustainable level of capital flows based on the level of flows during the run-up to the August election, a period of uncertainty during which flows were thought to be weaker than normal. Mexican hopes were fueled by optimistic voices in economic and market circles which continued to predict that capital flows would resume after the election. These hopes delayed consideration of the policy changes necessary to restore investor confidence and finance the large current account deficit.

A modest resumption in capital inflows and a slight appreciation of the peso following the August 21 election contributed to Mexican hopes. However, in line with U.S. officials' fears and warnings, the resumption proved to be short-lived. The September announcement of a new pact between government, industry, and labor officials, which reaffirmed existing exchange rate policies, included none of the appropriate macroeconomic adjustments.

Exchange rate pressures mounted in October. By mid-November, as tensions mounted in Chiapas and the inauguration approached, Mexico began to confront severe exchange rate pressures. Treasury and Federal Reserve officials continued to communicate to the Mexicans their grave concern that Mexico's policies were fundamentally unsustainable. Given the United States view of Mexico's economic situation, there were no drawings permitted on the standing swap lines. As I have said, it had been the Federal Reserve's and the Treasury's position all along that the United States would only allow use of the line to counteract short-term financial pressures such as those associated with political instability, not to prop up the currency in the face of policies that were fundamentally unsustainable.

By December 20, 1994, Mexico was losing reserves at an extremely rapid rate. The Mexican authorities decided on the night of December 19, 1994, that their exchange rate could not be defended, and notified us at that time. They announced the next morning an adjustment of their exchange rate band. Unfortunately, as Mexican authorities have since acknowledged, their devaluation

was not well handled, in terms of communication with the investment community, or with the international financial institutions. Moreover, the Mexicans did not accompany their announcement with any other new policy actions. Within 2 days, Mexico had no alternative but to float the peso. By waiting as long as they did to act, Mexico deprived itself of the ability to use other policy options that might have allowed them to avoid devaluation or to very substantially mitigate its consequences.

The combination of the mishandled devaluation, the further depletion of nearly half of the remaining reserves in defense of the new band, and continued political shocks created a loss of confidence that soon cascaded into a serious financial disturbance. By early January, Mexico was on the brink of default.

Let me be clear. As Secretary Rubin noted, this was not an outcome that had been foreseen, even by observers who were relatively pessimistic. Even those observers who recognized the unsustainability of Mexican exchange rate policy expected an exchange rate crisis of the kind that has occurred a number of times in recent years in Europe, not a set of events that would call a nation's ability to service its obligations into question.

Ultimately, it was Mexico's own choices—regarding macroeconomic policy during the year, and how to devalue and then float the peso in late December—which prompted its present difficulties. Treasury and Federal Reserve officials expressed their mounting concerns to the Mexicans throughout the year, but Mexico is a sovereign nation. The United States could not, and should not, have forced policy choices upon them.

The lesson from Mexico's experience is that policies make an enormous difference. There is no substitute for maintaining strong macroeconomic policies. No institution and no foreign government can save a country from that imperative.

Thank you.

The CHAIRMAN. Thank you, Mr. Summers.

Mr. Tarnoff.

OPENING STATEMENT OF PETER TARNOFF UNDER SECRETARY OF STATE FOR POLITICAL AFFAIRS, U.S. DEPARTMENT OF STATE, WASHINGTON, DC

Mr. TARNOFF. Thank you. Mr. Chairman, Members of the Committee, I welcome the opportunity to testify here today on behalf of Secretary Christopher who is, as you know, in the Middle East, and to be with you to discuss briefly our relations with Mexico.

The United States has fundamental national interests, both economic and political, in a stable and prosperous Mexico. What happens in Mexico affects our own security. It affects our own quality of life in many important ways. We also have a national interest in promoting regional progress in opening markets and in opening political systems, as the consensus of the recent Summit of the Americas in Miami so powerfully demonstrated. And we have an interest in maintaining America's leadership in this key region.

Mexico's political stability is vital to our own domestic security, and to the security and prosperity of Latin America. It is important to note that President Zedillo is committed to accelerating Mexico's

transition to democracy, and his actions bear out the positive steps he is taking.

For example, free and fair elections in Jalisco last month resulted in the victory of an opposition candidate as Governor of a state for the first time in Mexican history.

In January, consultations that President Zedillo led personally with opposition party leaders resulted in an important interparty agreement on political reforms.

Serious investigations involving recent political assassinations prompted the arrest of two significant political figures, validating President Zedillo's commitment to justice and judicial reform.

In Chiapas, President Zedillo has sought to regain authority over the area while continuing to offer to negotiate with the EZLN. More importantly, he has committed his Administration to addressing the social and economic inequities underlying the EZLN's complaints. This week, the Mexican Congress is meeting in special session, at his request, to address ways to improve the situation in Chiapas.

These measures are key indicators of Mexico's continued transition toward democracy. Progress already made is significant. Zedillo's own electoral victory came after the cleanest elections in Mexico's history. But the Mexicans recognize the need for further reform, and they are taking the necessary, and sometimes difficult, measures to achieve it.

Mr. Chairman, a politically stable, economically sound Mexico means that we can go forward with the Mexican government on a range of bilateral initiatives that directly affect the quality of life and prosperity of Americans, especially those who reside along or near our 2,000-mile border with Mexico. Our level of cooperation is already good. It can always improve, and I believe it will. Let me just highlight some areas of recent progress.

The United States and Mexico share a commitment to end cross-border crime and alien smuggling. Last month, the government of Mexico agreed to deploy additional elite police forces along the border, and to better secure bridges and border crossings against those who seek to enter the United States illegally.

The United States and Mexico stand together against illicit drug trafficking, which President Zedillo called Mexico's most serious national security problem in his inaugural address. Over the past 6 years, our cross-border cooperation has led to the seizures by the Mexican government of over 120 metric tons of cocaine, tens of thousands of arrests, and the eradication of thousands of hectares of opium poppy and marijuana. In a meeting just last month, we agreed with the Mexicans on additional measures to combat money laundering, facilitate extradition, and control the flow of precursor and essential chemicals. We also agreed on the need to dismantle trafficking organizations and bring their leaders to justice.

The United States and Mexico also seek to preserve our shared environment, a goal we have jointly pursued since the establishment in 1889 of what is today the International Boundary and Water Commission. As a result of NAFTA, the newly-created Border Environment Cooperation Commission and the North American Development Bank will help develop and finance badly-needed environmental infrastructure along the border.

Mr. Chairman, in closing, let me state that we believe that Mexico is on the path to financial recovery, to a more secure implementation of democratic practices, and to economic well-being for its people. The path is not an easy one and will require major sacrifices on the part of the Mexican people. President Zedillo is determined to succeed, and President Clinton and our Administration are determined to assist Mexico because we are neighbors and friends and because it is in our Nation's overriding security and economic interests to do so.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

Senator Shelby.

OPENING COMMENTS OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you.

Secretary Rubin, do you basically agree with Chairman Greenspan that the Mexican economic problem is deeper and more long term than perhaps a lot of people thought?

In other words, have the problems have grown larger in recent weeks, or the past 6 or 7 weeks?

Secretary RUBIN. I think, Senator, I would like to distinguish—it is a very important question that you have raised and one that we have——

Senator SHELBY. It is central to the whole thing, isn't it?

Secretary RUBIN. It is very important in thinking about what we do and how we do it, Senator. It is a very important question. It is one that we have discussed amongst ourselves, and with Chairman Greenspan and his people.

I would like to distinguish between three things, if I may.

As Chairman Greenspan said, the fundamentals in Mexico have changed enormously over the last, say, certainly over the last 6 years, and, really, I think from before that. There I think you have sound fundamentals which, if this program works and they can reestablish financial stability, can cause Mexico to be once again what it once was.

Second, the confidence of the markets in Mexico, and I think that is really what you're alluding to. Clearly, the longer this goes on, the more that confidence is eroded and the more difficult it is going to be for Mexico to reestablish financial stability, confidence, and an inflow of foreign capital, and thereby get back on its feet again.

The consequence of conditions, in that respect, having deteriorated over the past few weeks has been that the Mexicans have had to take additional and I think really quite courageous measures, which they announced last night and the President will speak to the nation about today, to get themselves back on their feet.

It is really their commitment to do what is necessary that I think is the actual requisite for this program working.

Senator SHELBY. Is that a long-term commitment to the measures that the Mexican government announced last night, or yesterday? They are going to have to be long-term, fundamental changes in the underpinnings of the economy.

Is that correct, Mr. Secretary?

Secretary RUBIN. Senator, I believe they have internalized the view that they must make a long-term commitment to fiscal and

monetary soundness, but our program and the disbursement of our funds is not dependent on that opinion of mine or anybody else's; it is arranged with tranches so that if, at any point, they do not continue on that path, then we can discontinue the disbursement of our funds.

Senator SHELBY. But is it basically, Mr. Secretary, going to be up to the Mexican government and the Mexican people to fundamentally build their economy, in other words, to fundamentally restore confidence?

It is not what we can do from this vantage point to rebuild the whole Mexican economy and the internal and external confidence that comes with it, is it?

Secretary RUBIN. Senator, I believe, as you have said, it is absolutely up to the Mexican government and the Mexican people to do that which is necessary.

On the other hand, because of the decisions that were made in 1994 and the financially precarious positions they put themselves in, I think in order to accomplish what they need to accomplish, once they have made the decisions to undertake such a difficult program, it is requisite that that will be supported by outside programs.

That is what our program is about, that is what the IMF program is about, and that is what the World Bank and IDB programs announced last night are about.

Senator SHELBY. What do you envision as a time frame, 5, 6, 7, 8, 10 years, to really fundamentally restore confidence in the Mexican economy?

Secretary RUBIN. I think confidence, Senator, will come in stages, and it is certainly our hope——

Senator SHELBY. What is the most important first stage then, if we are going to talk about stages? What is the fundamental most important first stage?

Secretary RUBIN. That is a very good question. I think the absolute requisite and first stage was the economic plan that the Mexicans, Mexican government, I should say, attached to the agreement we signed with them on February 21, 1995, and the program that they announced last night and that the President is going to address the nation on today.

That was the critical requisite first set of steps.

Senator SHELBY. That is the first step?

Secretary RUBIN. Yes.

Senator SHELBY. What is going to be the next big step? Is that going to be to fare with less in Mexico and produce more?

Secretary RUBIN. Unfortunately for the Mexicans, they're going to have to go through a very difficult period and I would say the next critical step is not so much a step as it is a continued commitment, which I believe they will have, a continued commitment to the programs they have undertaken so the markets see week after week after week after week, because, remember, they will have weekly money supply numbers now being published week after week after week, that they in fact are staying on the path they have committed themselves to.

Senator SHELBY. Chairman Greenspan, what about the new fiscal austerity measures they're talking about? Will these measures

be really effective in building confidence? Will it take more than that? And what will the effect of these huge tax increases be on the economy?

I think it is a complex situation down there.

Chairman GREENSPAN. Yes, it is extraordinarily difficult to tell. As the Secretary quite correctly points out, what we are dealing with here is an issue of confidence. Confidence builds up over the years in various different types of institutions and different types of economies.

The thing which concerns me most about this current situation is that, as I indicated in previous presentations before this Committee on this subject, we are in a global financial system situation in which very significant increases in the movement of portfolio investment are evident. That means when confidence is eroded or deteriorated, the impact is much more dramatic.

I do not know, and I suspect not very many people, if anyone, can really answer the question that you put because, while we can make some judgments about the negative effects of the tax issue and we can make some positive judgments about what happens when borrowing requirements of the central government decline, the focus, as I see it, has to basically be to try to find a path which gradually restores the type of confidence that indeed was built up in the Mexican economy and was very evident in the years 1992 and 1993, when there was this extraordinary flood of capital into the Mexican economy, essentially reflecting the view that the structural changes that had been involved were material, permanent, and on-going and that, in a sense, the international financial community wanted a piece of the action.

The results of recent missteps have shattered that view, and it is going to be extraordinarily difficult to build it back. I think it is going to have to be done step by step.

The CHAIRMAN. Senator Bond.

OPENING STATEMENT OF SENATOR CHRISTOPHER S. BOND

Senator BOND. Thank you very much, Mr. Chairman.

Chairman Greenspan, you have stated, I believe in your opening comments, that the good news is the Mexican government has avoided wage and price controls and further government control over the economy.

I share the concerns expressed by my colleague from Alabama, that some of the remedies, such as the increase in taxes, may appear, at least to me as an untrained economist, to be questionable steps.

What do you see in the economic plan, outlined last night by the Mexico finance minister, that would be good news from an economic monetary standpoint?

Chairman GREENSPAN. I think the first good news is that the markets have responded to it in a positive manner. I say that because it is tough enough, from the point of view of the United States, to understand how our economy works. To try to get a sense of the relationships of another economy, especially one which has changed as much as Mexico's, is extraordinarily difficult.

I think if you asked me, how do I answer that question, I would say my answer would be: If the markets are responding favorably,

meaning if the individuals who have the greatest commitments in that economy are moving in a favorable direction, that is good, and that is what we should try to push forward.

I cannot tell you that I have either looked at the detail of the program or know the internal structure of its impact well enough to give you a usable view other than to merely indicate that the way we test whether these programs are good or bad is the extent to which they impact on confidence.

In that regard, I hope what we are seeing today is an indication of something longer term.

Senator BOND. That is even, perhaps, a simple enough test for us to use.

I am interested in what you think the impact of the $20 billion guarantee has had on the possibility of currency speculation in Wall Street and other markets.

Was there any evidence that traders decided to test the ability of the United States to support the dollar when a majority of the Exchange Stabilization Fund reserves were tied up? Has this been a problem for the dollar?

Chairman GREENSPAN. I find it difficult to believe that that is a major issue. I certainly do not deny that the Mexican crisis has spilled over into our markets and has an effect of some dimension on the recent weakness in the American dollar, but it can't be a big issue.

As I indicated to the House Budget Committee the day before yesterday, the notions that people have that this will somehow impair the capability of the United States, should we deem it desirable, to intervene with the foreign exchange reserves that we have, is mistaken.

We do have the technical capability of making certain that the reserves we currently have will stay in place, and will be available when and if at some time in the future there is any interest in trying to intervene in these currencies.

Senator BOND. Thank you, Mr. Chairman.

Secretary Rubin, do we have any assurances that the Mexicans have stopped printing money, that they have stopped the pesos from rolling off the presses, that the monetary supply is not expanding?

Secretary RUBIN. Senator, that obviously is an issue that we have also been very much focused on. In fact, we have had people from Treasury in Mexico a fair bit of the time as we have worked on this program.

Their real money supply, the money supply adjusted for inflation, has actually been declining, and it is our judgment that they have adopted an appropriately stringent monetary policy and that they are on track toward fulfilling it.

But the basic answer to your question, Senator, is that their real money supply is in fact declining.

Senator BOND. Can you give us an idea of how the funds we are sending to Mexico are going to be used?

There are some skeptics who charge that maybe we are just paying off bond investors who are getting very, very high rates of interest, rather than using those funds to buy up excess pesos.

Secretary RUBIN. Senator, the funds will be used, and there are many different technical mechanisms that may be used, but the bottom line is that the $3 billion we are now disbursing will be used to stretch out the short-term public debt, the debt of the Mexican government, into long-term debt in one fashion or another.

The basic problem they have had is that they got themselves into this position where they had this vast amount of short-term debt, and what they needed to do was to reschedule it. That is what this $3 billion at least will be going toward accomplishing.

Senator BOND. There is a report in the New York Times today quoting an unnamed U.S. official expressing the view that Mexico is dragging the dollar down.

Is there anything we need to do about that, any steps we should take to deal with that problem?

Secretary RUBIN. Senator, I also saw that comment. The behavior of the dollar is obviously a very complex subject. It is one that I have not commented on since I've been Secretary, other than to say that we believe very much in a strong dollar and that a strong dollar is in the interest of this country. But let me say this, if I may. I do not believe, in fact, I have no doubt that the program we have undertaken with respect to Mexico has not had any material impact on the problems that the dollar has had.

If you get analytic and go beyond perceptions, I do not think there is any reason on why it should have an effect on the dollar.

Senator BOND. Thank you, Mr. Secretary.

Secretary RUBIN. People who make comments to the press, on occasion, are less knowledgeable than they might be.

Senator BOND. Thank you, Mr. Chairman.

The CHAIRMAN. I indicated earlier that we would attempt to recognize in order those who gave up their opportunity to ask questions.

I do not want to create a problem where there shouldn't be one.

Senator Dodd has come in. He hasn't had a round at all. And it will be an extra 5 minutes.

Will my two colleagues yield to Senator Dodd?

Senator Dodd.

OPENING STATEMENT OF SENATOR CHRISTOPHER J. DODD

Senator DODD. Thank you, Mr. Chairman. I apologize to the witnesses and my colleagues. My alma mater in high school had their program today and I had to be there this morning, so I apologize for not being by here earlier.

Let me just say, briefly, Mr. Chairman, to our witnesses, I read Jack Kemp's statement last evening, and had a chance to meet with him briefly as he left the Committee room.

I want to commend Jack Kemp and Chairman Volcker who are here. Even though Jack Kemp has disagreements about how this ought to proceed, I want to commend him for the notion that it is critically important that we do everything possible to inject as much confidence as we can into the Mexican economy. If there is one word—it seems to me, there ought to be—in the moniker of this process, it is confidence.

Whatever particular processes we try to resolve this problem, if there is an expression that becomes the impression that there is a

total lack of confidence, then any process we try will fail in my view. It is critically important that those who speak on this issue be very, very mindful, I think, of how important it is that a word or an offhand comment can have a profound, profound effect on the success of any particular process we try here. The implications go far beyond Mexico; they include this entire hemisphere and a good part of the developing world, if we do not act carefully.

I want to commend Jack Kemp and Chairman Volcker, even though there is some disagreement.

I want to come quickly, if I can, to what Jack Kemp has recommended as a proposal. I understand Chairman Volcker disagrees with that approach, and believes the approach taken by the Administration makes more sense.

I am going to begin with you, if I can, Chairman Greenspan, along those lines.

First of all, I would like you to describe the role the Fed has played in developing this package with regard to Mexico.

I will use the words—you tell me if I am off—a full partner. Is the Fed a full partner with Treasury in this venture?

Chairman GREENSPAN. Senator, we have been engaged as a consultant to Treasury. We have chosen not to be involved in the specific negotiations with Mexico. We have decided that this is an issue of finance ministry to finance ministry.

To the extent that it is relevant, we have had conversations with the Bank of Mexico, as we do on an on-going basis, but the lead here should and has to be the Secretary of the Treasury.

Senator DODD. I appreciate that. I appreciate your answer to the question.

I wonder if you might—you did this once, a few weeks ago. We had a discussion on derivatives and you did a marvelous job, I thought, in just a few sentences in simple terms of describing why it was important in that particular issue that we understand what happened in Orange County.

I wonder if you might engage us, if you would, in another exercise here, to explain in simple terms for an audience as to why it is important that we proceed with this initiative, and what would be the implications of not going forward?

Chairman GREENSPAN. Senator, the reason for going forward essentially has not changed since this whole crisis erupted.

The choice that confronts the American Government is whether or not a sovereign nation, such as Mexico, is allowed to default, which indeed it would have done had no program been initiated. The consequences of that, unlike a default judiciary procedure that we have in the United States which would contain the problem, is that there is no such basic bankruptcy statute for a sovereign nation.

For Orange County, we had Chapter 9 of the U.S. Bankruptcy Code. For a private corporation, we have Chapter 11 and Chapter 10 and the like, and there is a formalized procedure which contains the adjustment processes of the default.

In this particular circumstance, there is no basis for that. What would tend to happen is, in the event of default, there would be a massive movement of funds, basically causing the default of large parts of the private sector and the commercial banking system with

consequences to Mexico and, I think in a contagion manner, to other areas of the world and the United States, which, in my judgment, was not an acceptable alternative.

This led to an alternative which I personally do not find very enticing. That is why I used the term the least-worst alternative, because doing what we are doing has a number of downsides, the moral hazard issue being a major one.

I understand the concerns people have about the use of taxpayer funds, which I do not think are particularly at risk, but I am very much concerned about the precedential nature of this, about the broad moral hazard issues that are involved. I think it would be better if we had a mechanism which enabled a restructuring, such as private institution is able to access.

Not having that, what we are trying to do, as far as I see, is to create a situation in which confidence can be restored, the Mexican economy can be rebalanced, and the problems that would occur, as a consequence of default, are avoided.

Senator DODD. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Faircloth.

OPENING COMMENTS OF SENATOR LAUCH FAIRCLOTH

Senator FAIRCLOTH. Thank you, Mr. Chairman. If you gentlemen please will be brief, I've got several questions and I do not want you to burn up my time.

Mr. Summers, in November you said that a decision was made not to allow the Mexican government to draw on the swap lines in mid-November.

What has changed from November to now that makes you support $20 billion? And please be brief.

Mr. SUMMERS. I will be brief, but I think there are many factors that account for the difference.

Senator FAIRCLOTH. Give the main one. I do not have time to hear all of them.

Mr. SUMMERS. Among the crucial factors are the global significance of a Mexican default, as Secretary Greenspan described, and the importance of avoiding it, and the kinds of strict conditions that the Mexicans have been prepared to accept in the context of their new economic program.

Senator FAIRCLOTH. Mr. Rubin, what is the balance in the Exchange Stabilization Fund this morning?

Secretary RUBIN. Senator, there is approximately $29.5 billion of usable funds.

Senator FAIRCLOTH. Of usable funds?

Secretary RUBIN. Yes.

Senator FAIRCLOTH. How much is in there that is not usable?

Secretary RUBIN. There is about another $8 billion that is in there but is not usable.

I think if you want to think of the ESF in terms of what can be used, it is roughly $29.5 billion.

Senator FAIRCLOTH. Have we used any to prop up our currency, the dollar?

Secretary RUBIN. Absolutely.

Senator FAIRCLOTH. We have?

Secretary RUBIN. Oh, I am sorry. I misheard you. Did you say can we or have we?

Senator FAIRCLOTH. Have we.

Secretary RUBIN. We announced an intervention about a week ago, if I remember correctly.

Senator FAIRCLOTH. The President's fiscal year 1996 budget says that the net position of the Fund is $18.3 billion.

Secretary RUBIN. I truly do not know, Senator, what that refers to, and I can get back to you with a response. But I can tell you with certainty that there is $29.5 billion of usable funds.

Senator FAIRCLOTH. I hope you are right.

Secretary RUBIN. Let me assure you that I am right, and let me also get back to you with a response to the difference between that and the number you've mentioned.

Senator FAIRCLOTH. I do not question you being right.

Now, back a month or so ago when you appeared before pretty much the full Senate, we were told that $40 billion would be a gracious amount of money. In fact, we only asked for $40 billion, and really thought $12 billion was going to do it.

Twelve billion dollars was the original amount that it was going to take to clean Mexico up, but we were proposing $40 billion so that we would have enough money to do it, with an excess to convey to the world that we fully intended to ride it to the end. Did you really think once we said we would put up the money, that it would bring such a burst of confidence, we really wouldn't even have to use it?

What do you say today?

I hear $52 billion now and rising.

Secretary RUBIN. I think, Senator, had we acted quickly at that time with the $40 billion program, the probability is that what we said at the time would in fact have happened, that confidence would have been restored very quickly, that we would have had to use some, but not all, of that money.

Unfortunately, as Chairman Greenspan testified, the conditions have deteriorated a lot in the time that it has taken to get this done, and as consequences have become more difficult, I think the $37.8 billion, which is the amount, really, of medium-term money we have now, is fully adequate to accomplish the purpose.

I think we have a sound program, and I think it should work as long as we and the Mexicans fulfill our commitments.

Senator FAIRCLOTH. Of course, Chairman Greenspan is acutely aware that I am much more worried about our own dollars than I am the Mexican's.

We say we have excess pesos because they are printing a lot of money we are buying, and we have heard from different ones to buy up the excess pesos. Jack Kemp said we needed to buy up this excess of pesos. We have heard that several times. Is that reasonable?

Secretary RUBIN. It is our view, Senator, that for Mexico to accomplish what needs to be accomplished, they need to go into an exceedingly stringent monetary mode. That is the commitment they have made. Thus far, they have been on the path toward that mode, or, I should say, they've been on that path in the time since we have signed the agreement.

Last night, they reinforced that commitment. They are actually shrinking, shrinking their money supply on an inflation-adjusted basis.

Senator FAIRCLOTH. We have printed, oh, best I can figure, about $40 billion ourselves from Mexico I to Mexico II.

I am close to $40 billion in money we have printed. Are we talking about buying up excess pesos with excess dollars?

Secretary RUBIN. If I understand your question correctly, the answer is no, Senator.

Senator FAIRCLOTH. Chairman Greenspan, the last time we were together I asked you, if the Balanced Budget Amendment failed, would it cause a decline in the dollar against other industrialized currencies?

Now, this was a couple of days before the vote, and you very nicely avoided giving me an answer that I could understand.

[Laughter.]

Would you mind giving me one today?

Chairman GREENSPAN. I am delighted, Senator, that I succeeded in obscuring the answer at the time.

[Laughter.]

The truth of the matter is——

Senator FAIRCLOTH. I am easy to confuse.

[Laughter.]

Chairman GREENSPAN. The truth of the matter is, I was not sure how the response would come out.

In retrospect, as we look at the various different measures of how we view our exchange rate, it is clear that something happened when it became evident that the Balanced Budget Amendment was going to fail. That is, the 10-year forward rate for the dollar viz-a-viz the Deutschemark and the yen began to fall very rapidly after having been rather stable for a period of several weeks earlier.

The apparent softening in economic growth in the United States, as I indicated to the House Budget Committee a couple of days ago, did cause some weakening in the spot exchange rates basically because the two- and three-year interest rates in the United States denominated in dollars began to come down with the expectation that economic activity was slowing, but the 10-year rate remained remarkably stable, meaning, in effect, that the underlying view of the dollar in the longer term was not being affected by short-term money market or interest rate considerations.

On the day either before or subsequent, I've forgotten which, when it obviously became clear that the Balanced Budget Amendment was in trouble, the long-term, 10-year forward exchange rate fell sharply, implying that something other than short-term interest rate movements was involved.

A number of people in the markets were of the opinion—I suspect there is something to this—that it was caused by the failure of the Balanced Budget Amendment.

I, as you know, was not supporting the Balanced Budget Amendment, so it is not an issue of looking at something which I thought would have a significant impact; I was quite surprised at the way the markets responded to that.

What I interpreted to be the case, if in fact that is what happened, is a view that the fervor to get the deficit down which had

been building in recent periods, and had, in my judgment, a very positive effect on the markets, was perceived to have been significantly undercut. I do think, in retrospect, there has been this judgment out in the marketplace. After a long period of very little reaction to this chronic, very large budget deficit which has spilled over into a significant current account deficit, the markets began to react to that.

While there is no way of proving it in any analytical way, I do think the broad view that prevails in the marketplace, that that was a crucial action, at least has some verification in disaggregating the structure of our exchange markets.

Senator FAIRCLOTH. I think we sent, clearly, a message to the financial communities of the world that we do not intend to cut spending. We are going to talk about it, but when the reality comes of doing something about it, we are going to take a walk. We just simply are not going to face up to it. If we wouldn't pass the Balanced Budget Amendment, why do we think we are going to cut spending?

Maybe we will. I've been hoping so for 35 years. I hope so again.

Chairman GREENSPAN. Senator, I must say to you that I sense, as I indicated to the House Budget Committee, that—appearing as much as I do now in front of Congress, which has been extraordinary, I have a pretty good sense of how you and your colleagues on both sides of the Capitol view this issue—there is a difference now.

I think it is the greatest awareness of the importance of getting the deficit down that I have seen in 10 or 20 years.

Senator FAIRCLOTH. I am excited by it and I hope you are right. I hear the conversation, but I have not really seen any action.

The CHAIRMAN. Senator Bennett.

OPENING COMMENTS OF SENATOR ROBERT F. BENNETT

Senator BENNETT. Thank you, Mr. Chairman. My position on these matters is probably pretty well-known. I made my opening statement yesterday, and made it fairly clear where I stood.

I want to repeat again, just for the record, Mr. Secretary, my admiration to you for the energy with which you have pursued this, and my absolute conviction that there is nothing whatsoever to the innuendoes that are floating around that you acted in any way in a manner that would challenge your integrity on the conflict of interest issue. If you missed it, Senator D'Amato, as Chairman of the Committee, associated himself with that, and we recognized you have worked day and night in an effort to solve this problem, and we salute you for your energy and your dedication.

I would ask, for the record, if you would respond in writing to Jack Kemp's four questions. I will not repeat them here. You have received them, and I think it would be useful if you could give us a response to those because Mr. Kemp represents a very articulate spokesman for a particular point of view that has been part of this debate. Perhaps more important than this debate, it is part of the on-going issue of what the United States ought to be doing with respect to its monetary policy.

Now, I have pursued Chairman Greenspan on this issue often enough in his appearances before the Committee and had him say,

on the record, that if we would have had a gold standard, this crisis would not have occurred.

We are really talking about the discussion of the whole question of fixed exchange rates and stable currency tied to some kind of measure.

I referred to that in my statement on the Floor last week when I used the quote from Deuteronomy, Chapter 25, that Ruth Bader Ginsburg used in the National Prayer Breakfast, when she talked about, through the Scripture, the importance of standards that do not move.

Deuteronomy says in the law, you have only one measure in your bag; do not have two, a big one and a little one, to use during the occasion.

So, as I say, my views on this are pretty well-established and I will not go through them again.

I would like to, however, make a point that came out of the testimony.

Mr. Secretary, you referred to it. Mr. Summers, you hammered it home more clearly. And I want to make a point off the point.

The Secretary says that even the pessimistic observers who saw the Mexican situation as unsustainable did not expect a crisis that would bring Mexico to the brink of default. The probability of crisis is always very low, and the crisis is foreseen by few, if any.

Mr. Summers, you state:

> Let me be clear. This was not an outcome that had been foreseen. Even observers who foresaw the possibility of an exchange rate crisis expected the kind that has occurred in recent years in Europe, not a scene of events that would call a nation's ability to service its obligations into question.

I hope the implication that comes out of this is not correct, but to make sure that it is not correct, I am going to raise it.

Just because it was not foreseen, does not mean that we have an excuse for not changing our policies. Just because nobody saw it coming, therefore, we must not expect it won't come in the future.

It must be remembered in this Committee that nobody saw the S&L crisis coming. We had much of the same rhetoric as we approached the S&L crisis of people saying, "Well, you know, this can be contained. The dollar value will be such and such." And then, in retrospect, we look back at it and say, "You know, conventional wisdom was wrong."

I hope we can draw a lesson of humility out of the fact that none of us foresaw this.

I am not putting any blame on anybody. Heaven knows, I have forecast things in my business that did not come to pass, and I assure you there was no moral turpitude in my inability to forecast correctly.

But there is a sense of humility that ought to come out of this whole experience that should cause us to say, maybe Jack Kemp is not as nutty as we think.

[Laughter.]

Maybe the things he is suggesting here should have been considered, because the conventional wisdom that told us this was not going to happen has been empirically proven wrong. Let's start looking around and opening up to some new concepts.

I conclude with a comment I had at dinner this last week with a Wall Street currency trader who was a Ph.D. economist.

He said:

> I have learned that being trained in economics, to the degree that I was, sometimes is a hindrance because my tendency is to say, 'the markets are not acting properly based on what I learned in school. Markets should not be doing that.'

He continued:

> I have had to learn to say, when that happens, 'that means what I learned in school was wrong. I have to learn to listen to the markets.'

We have a terrible situation here with which we all are grappling, I think in good faith, in an attempt to solve it. I am not looking to point fingers or score political points, but I do think the underlying lesson that comes out of this is that we can't take any comfort in the fact that we did not see it coming.

If anything, the fact that we did not see it coming says to us, we have to start looking in new areas for new lessons that we may not have learned in the past.

Thank you, Mr. Chairman.

The CHAIRMAN. Do you care to respond, sir?

Secretary RUBIN. If I may, Senator, you have been enormously and very constructively involved in a very complicated problem over the months, over the period of time that we have been involved, and we greatly appreciate the intellect and the thoughtfulness that you have brought to this.

Let me assure you that our view of the experience is to learn from the experience, and we absolutely agree with you on that.

I think you would find, if you were sitting around the Treasury as we work our way through this with our consultants from the Federal Reserve Board and elsewhere, that we are extraordinarily open-minded and receptive to all thoughts from all quarters.

We absolutely agree with you.

Senator BENNETT. Thank you.

The CHAIRMAN. Senator Sarbanes.

Senator SARBANES. Thank you very much, Mr. Chairman.

Chairman Greenspan, I just want to put one question to you that is aside from this issue, but it is in response to the question put to you by Senator Faircloth.

In the course of getting the deficit down, would you put deficit reduction ahead of tax cuts?

Chairman GREENSPAN. Yes, I would, Senator.

Senator SARBANES. Thank you very much.

Now, on the Mexican question, you were asked a question for the record when you testified in February on monetary policy. You were asked whether by December 20, 1994, when Mexico devalued the peso, they had any alternative.

Your response to that question was:

> By December, given the policies that had been implemented in Mexico and the consequences of those policies, in terms of lost reserves and increased short-term dollar index debt, the Mexican authorities probably had no realistic alternative to allowing the peso to float.

That was your response.

Chairman Volcker agreed with that.

I'm talking about that point in time, which is how the question was put. I am not going back to an examination of months earlier of how things might have been done differently. For purposes of analytical framework we need to have some reference points here.

Secretary Kemp disagreed with that, and I cannot fathom any way that there was an alternative. I think I agree with your observation.

In fact, I think you said this morning that if Mexico had run out of reserves, they could not have sustained the peso in any event at that point in time. Is that correct?

Chairman GREENSPAN. Yes. By that time, their reserves of dollars had dwindled to the point that they were within days of literally running out of them.

The issue, therefore, is that if you are endeavoring to support an exchange rate, you need the other currency to do it.

If you do not have the other currency, there is no mechanism that you can employ, with the exception of an endeavor to try to attract new inflows of dollars at that point, which presumably, at least theoretically, could have been done with a very major rise in interest rates, but I suspect, at that point, that confidence had so eroded that interest rate increases probably would have been very ineffective in obtaining significant amounts of reserves to enable the exchange rate to be supported. My own view is that, had they done that at an earlier time, they may well have been successful, but by December 20, 1994, the die was cast.

There was too much in the way of reserve loss and not enough potentially available in the days ahead to do anything but to float the exchange rate because, if you do not have the currency of the exchange rate you are working with, there is no mechanism to support it.

Senator SARBANES. We have received the advice that the Treasury Department should advise Chairman Greenspan that it wishes him to deploy the Exchange Stabilization Fund solely to purchase pesos on the open market.

What is your reaction to that advice?

Chairman GREENSPAN. I assume the purpose of that would be to firm the exchange rate.

If you had a situation in which a certain level of confidence existed in the marketplace, if you began to engage effectively in open market policy, which is essentially selling long-term securities into the market for short-term claims, the immediate affect would be twofold.

No. 1, you would get an increase in short-term interest rates, which is exactly what happens here in the United States and in every central bank, and, No. 2, you would get a firming of the peso in that particular context.

If in the process there was an increase in general confidence that monetary support—a firm monetary policy—was in the process of occurring, you might then also get some decline in long-term peso-denominated interest rates.

The difficulty, however, is that it is extraordinarily unclear as to what happens to short-term interest rates in that context, and whether the rise that is required to sustain a significant improve-

ment in the peso is of such a magnitude that it undercuts the banking system.

I myself do not know where those relationships are. I suspect that the Mexicans do not know. The reason, essentially, is that we have not had a Mexican economy functioning in an open market and private sector sense at a relatively low inflation rate long enough to know how that system works.

So I know the direction of the problem. I do know, were they to do that, short-term interest rates would rise very dramatically. Whether they would have risen as much as they have now if that had been done at an earlier stage, I very much sincerely doubt.

If you are merely looking at it from the point of view of now, the state of confidence has been deteriorated so much that it is really quite unclear as to how the markets would respond, and whether or not you would get enough of an improvement in general underlying confidence is, at this stage, very much unclear.

Senator SARBANES. Thank you.

The CHAIRMAN. Mr. Secretary, yesterday the Committee staff received an index detailing the documents in Treasury's possession as it relates to Mexico and Mexico's problems prior to the December collapse and thereafter. That index indicates approximately 3,490 pages of documents.

To date, we have received only about 552 pages. Would you make an effort to see to it that these documents are made available? Obviously whatever information is classified will be seen only by those people who have necessary clearance.

I would appreciate that. We could then put aside that situation.

I will make this index available to you so you can see the documents we are talking about.

Secretary RUBIN. I would be delighted, Mr. Chairman.

As you know, our staff is working with your staff to try to work out an accommodation that meets your needs and at the same time protects our ability to function as an institution.

The CHAIRMAN. Sure.

Secretary RUBIN. I am confident that we will be able to work out appropriate arrangements.

The CHAIRMAN. I appreciate that.

Secretary RUBIN. Let me say it this way. We certainly will act with all good faith and good will to work out appropriate arrangements.

The CHAIRMAN. I realize that, and that is why I mentioned it in the manner I have.

Secretary RUBIN. OK.

The CHAIRMAN. Mr. Summers, there has been, and there is no doubt about it, a question—one that has been raised publicly and by the media—about the exact nature of the Administration's involvement in the impending problems in Mexico and, specifically, the peso devaluation.

Now, there have been a number of stories about what advice you gave, what you knew, when you knew it, and what you did or did not transmit to the Mexican officials. This is your responsibility.

Let me ask you: Did there come a time in September, October, or November when you counseled Mexican officials to devalue the peso?

We have all been dancing around this, and I do not understand why someone has not just directly asked you—or maybe they have—what exactly did we do? At some point in time, we owe it to ourselves and we owe it to you to find out what exactly we did or did not do, and what exactly was our position.

It may very well be the case, as Senator Bennett indicated, that we learn from experience. Who knew what was going to take place?

Would you try to answer that question?

Mr. SUMMERS. Senator, there were many conversations between Treasury officials and Mexican officials, Treasury officials at all levels, and their counterparts in the Mexican government, and between U.S. central bank officials and the Mexican central bank.

Those conversations by the fall emphasized Mexico's policy path was, in our judgment, unsustainable; that, unless they were prepared to take some other substantial policy action, it would be necessary for them to devalue, but that it was possible that with other substantial policy action a devaluation might be necessary.

The CHAIRMAN. Would you give us a time line, for example, September, October, November? When did those conversations——

Mr. SUMMERS. I would say that message was conveyed with increasing urgency through the fall.

The CHAIRMAN. OK.

Now let me ask you, did you see them taking the kind of actions that you thought would ameliorate the situation?

Mr. SUMMERS. They did not——

The CHAIRMAN. For example, did they stop printing pesos or did they speed up the presses?

Mr. SUMMERS. There was not the kind of sharp contraction in credit conditions that would have been necessary to offer a prospect of putting policy on a sustainable path, and we expressed that very clearly.

The CHAIRMAN. Let me share with you some speculation. My colleagues have talked about it. The media has talked about it. Maybe it is unfair to ask you to respond to it, but there seems to be a sense—and although Ralph Nader brought it up yesterday in a manner that was perhaps too accusatory, certainly there are people who share a sense that a lot of this took place—that there was a failure to blow the whistle and to say, "What are you doing?," and that this Government—and, by the way, this is nothing new because past Administrations might have been involved—put a shiny spin on a situation that was less than good; that this Government created this glossy image of a Mexico that was a global paradise and a country that had emerged from the shadows to become a shining example of what the free capital market system could do and was doing, and in order not to diminish this illusion, we acquiesced.

There are a number of reasons why we would do that, and why they were reluctant to take action.

No. 1, they had elections. We do it here, too. Democrats, Republicans, we delay taking tough steps right before an election. I have not seen any President who wants to advocate policies that may require some citizens to make sacrifices before an election.

But there seems to be a sense that this problem was so serious and was only getting worse, that this was not just an ordinary,

small problem. If you were indeed counseling them in September, October, and November, given the fact that we did not want to precipitate a crisis prior to the election and then even after because of other events, given the fact that we withheld information that should have been made available to Congress and to the public, and, as a result, a handful of the wealthy, the oligarchy, down in Mexico did their own thing—they recognized that the government would devalue the peso—I think they sold short, and here we are now, American taxpayers, in a situation here, because we want to keep our neighbors to the south with whom we share a border and who is a great trading partner from collapsing.

How do you respond to that?

Do you understand why this issue is being raised? What did we know, and when did we know it, and did we act in an appropriate manner?

Mr. SUMMERS. Mr. Chairman, I think the question you have asked raises a number of critical issues.

It has been the traditional policy of the Treasury and the Federal Reserve, and I think of treasuries and central banks around the world, not to seek to, under any circumstances, undermine confidence in the currency of other countries by making public statements about their currencies.

It was in that context that we did not—that such statements were not made. We were concerned about the situation and expressed the concern to Mexican officials.

I think it is fair to say that a reading of the press or of the financial market commentary during the fall of what the rating services were saying would reveal that there was an active discussion of the situation in Mexico, and of the prospects for the Mexican economy and of the Mexican financial situation.

It has not been seen, nor, I think, all things considered, considering the various interests involved, were it to be appropriate for U.S. officials to be in the position of providing warnings to the market with respect to currencies.

The CHAIRMAN. I understand some of that. My time is up.

I am now going to turn to Senator Moseley-Braun, and then I will come back to this issue. I think there is a pretty fine line. No one is saying, advise investment houses, et cetera, but if we loan ourselves to being very supportive in a manner which indicates something that is really not, that there is a great strength when we know there is a tremendous weakness, I think that is what we have to look at.

Some people have a feeling that what we did exacerbated the problem; that we loaned ourselves to literally covering up the magnitude of this problem.

Again, I am not suggesting ulterior purposes as it relates to anybody who was handling this, but I am just telling you that the logical consequences are the kinds of articles that you see, such as the four-page article in the Washington Post that sets forth a history of this, and how people came to feel that maybe we should have been more forthcoming.

I do not know exactly how you do that, but we will get back to it.

Senator Moseley-Braun.

Senator MOSELEY-BRAUN. Thank you very much, Mr. Chairman. I have essentially three questions.

One of the things that has been talked about in all of this—or maybe we have not talked enough about—is the effect of this issue and this whole situation on ordinary people.

Certainly, in Mexico, the Chiapas Revolt was, if nothing else, one of the matches that started the conflagration, exacerbated it, and made this problem happen.

So the question becomes: With regard to the plan that Mr. Ortiz disclosed yesterday, to what extent has any thought been given to whether or not this plan is going to make worse the political and social instability and the quality of life for ordinary Mexicans?

That is my first question.

My second question is: Given the house next door analogy, to what extent does what happens in Mexico then affect the citizens in this country?

Are we moving into a situation in which we are going to have immigration issues and all the dislocations giving rise here by virtue of what happens following this plan?

The American people, I think, have a right to ask, what specifically are our interests in preventing further erosion of the situation in Mexico? Are we just bailing out rich people and the Mexican government and propping up an economy that Mexican Nationals have abandoned?

What specifically are our interests?

Those two questions are to Mr. Rubin.

The third question, to Mr. Greenspan, is: You have described the Administration's program as the least-worst of possible solutions, so I guess my question to you is just straightforward: Do you endorse Treasury's approach? Do you think they are on the right track?

What else would you do?

Chairman GREENSPAN. The answer is yes, I have endorsed the approach because I do not see what the alternatives at this particular stage are.

I do think it is unfortunate that the situation was allowed to fester to the point where these types of actions were required, and indeed I am sure that, in retrospect, everyone from the Mexican government officials to everyone else, if the clock could be set back, would have taken numerous different types of actions.

As we have all indicated, a more appropriate monetary policy earlier in the deterioration could very well have fended off all of this. But that is water under the bridge.

Having gotten to where we are, at this stage I see no credible alternatives to doing what is currently being done.

Senator MOSELEY-BRAUN. Thank you.

Mr. Rubin?

Secretary RUBIN. Yes. Thank you, Senator.

On the first of your questions, I think the simple answer, although it is a very complicated and I think very important question, the simple answer is that Mexico basically faces two very difficult paths.

One is to undertake the kind of program that the Cabinet announced last night and that President Zedillo will address the nation about today.

That, in their judgment—and we very much agree with their judgment—is a very hard path to travel, but it offers them the best probability—and we think a good probability if everybody fulfills their commitments and does what they need to do—of becoming a healthy economy again. But it is going to be a very difficult time for the Mexicans that you referred to.

The alternative is not to take such a path. In which case, in our judgment, the consequences for Mexico and for ordinary Mexicans will be far worse, and will be far longer-lasting.

Now, I have forgotten whether it was the World Bank or the Inter-American Development Bank, one or the other did announce a $1 billion support package for the social safety net which, while not enormous on the one hand, on the other hand is a useful contribution to try to provide some social safety net for those who are most severely affected.

On the second point, I think the best defense for this country, with respect to illegal immigration and all the other issues that affect us if Mexico is in trouble, is to have an economically healthy Mexico.

Our stakes, as we see it—we have no interest—we have zero interest in bailing out wealthy investors here or there, and we would not spend one nickel for that purpose. Our judgment is based solely on the question of restoring Mexico as a trading partner—Mexico has been our third-largest trading partner, as you know—by making sure that we do not have national security problems that emanate from a country that shares a 2,000-mile border with us, and in creating the kind of healthy economy that will give Mexicans opportunities in Mexico and thereby minimize illegal immigration.

Senator MOSELEY-BRAUN. I will be brief because my time is almost up, but, Mr. Rubin, I think one of the problems with all of this is that, having taken the bucket to try to put out the fire next door, there are a lot of people who do not think there are enough buckets on our side of the fence to even make a difference. That is one of the underlying problems with this whole issue.

We heard some testimony yesterday about alternatives; what we can do to forestall these kinds of problems in the future, but I am afraid, for one, that what we have done here is too little too late.

We are doing the best we can with a bad situation. There is no question, I think in my mind, that the tensions for political and social instability are heightened by all of this, but we just do not have enough resources standing alone to put out all these fires.

Secretary RUBIN. Senator, if I could, I would like to respond to that because I think you raise an exceedingly important point.

There are no certainties in life. As we have said all along, there are risks, although I absolutely feel that the risks of doing nothing are just vastly greater than the risks of acting.

But, in our judgment—in our judgment—if Mexico does what it is committed to do, and we do what we have committed to do, we think there is a real chance that this can work.

Let me point out as evidence of that, the peso was at 7.85 per U.S. dollar yesterday. With the announcements that the Mexicans made last night, the peso is now at 6.25 per U.S. dollar.

I am not saying for sure, Senator, this will work. Nobody can tell you that for sure. But I will tell you this: They have the pieces to make it work. I think what we have to do is do everything possible to help them with the courageous decisions they have made to give it the chance to work.

And if we do give it that chance, I think there is a good chance it will work. The best evidence is what the peso has done today.

What we have to avoid is doing things that undermine market confidence in their programs and what we are doing.

Senator MOSELEY-BRAUN. I thank you very much.

The CHAIRMAN. Senator Mack.

Senator MACK. Thank you, Mr. Chairman. I want to try to concentrate on two areas. One is the political environment in Mexico, and the other is on the peso. Let me start with that first.

I think in discussions already today, we've heard the concept that no alternative to the devaluation of the peso was available in December. I guess I would ask Mr. Summers, instead of devaluing, could not the Mexican government have maintained confidence in the currency by withdrawing excess pesos from the financial system?

Was that something that you all considered and discussed prior to that?

Mr. SUMMERS. I think Chairman Greenspan spoke to that a few minutes ago. It is a very important question.

I think it would be my judgment, as I interpreted it was his judgment, that by the time you got to December no amount of tightening credit conditions, withdrawing pesos, and accepting interest rate increases would have been sufficient to induce enough capital to return to have made it possible to build up reserves to the point where the exchange rate would have been sustained.

Perhaps, had such a policy been initiated at some earlier stage, it is certainly possible that the exchange rate could have been defended successfully. And that was a point we made to the Mexican Finance Ministry in the course of the discussions.

It is important to understand that after April 1, 1994, the Mexican central bank was independent, so it was making those decisions in a way that was separate from the U.S. Government.

What we were told was that they were not prepared to undertake a sharp increase in interest rates. In that context, we thought the policy was unsustainable.

Senator MACK. So what you are saying is, you agree that at that point in December there was no other choice?

Mr. SUMMERS. I think by the time you got to December 20, there was no alternative. That's right.

Senator MACK. Was that posed to you at that time?

Did you, in essence, agree with the Mexicans at that time?

Mr. SUMMERS. As a matter of policy, we do not talk about specific conversations. I am told that I am not, because of an Executive Order, to talk about specific conversations on specific dates.

Senator MACK. I have a whole series of questions I would love to pursue on that, but I am not going to at this time.

I guess what I would ask you next, then, is: If we are not going to address the issue of the value of the peso in the plan that has been put together, how in the world are we ever going to increase the confidence in the Mexican economy?

Mr. SUMMERS. The Secretary may want to speak to this, and probably will speak to this in addition to what I say, but certainly the commitments on monetary policy that the Mexican government entered into with the IMF, with us, and that they reaffirmed in their statement yesterday, are about their recognition of the need for tight credit conditions that limit the supply of money that will produce stability in foreign exchange markets.

Senator MACK. Let me address that question, though, because I think this is a point of real disbelief, at least for some of us.

I think that those conditions basically were to maintain negative real money growth. Now, if you are having inflation rates, which they are now projecting, that would be 48, 49, or 50 percent, that means they could still expand money growth by 40, 45 percent.

That is a question that, frankly, is of great concern to me. Beryl Sprinkle exposed the problems associated with using this policy tool in a 1977 book entitled, "Winning With Money." I am not very comfortable with what you all have concluded.

Secretary RUBIN. Senator, could I respond to that? Then perhaps Chairman Greenspan or Under Secretary Summers would like to respond.

If they have a 40 percent inflation rate, and if, just for the sake of discussion, they were to expand the supply of money at 17 percent which is, as you know, part of the IMF agreement, they would be decreasing the real money supply by 23 percent.

Senator, with that kind of a contraction of the real money supply you would have extraordinarily high interest rates. That is a very, very constrictive monetary policy. That is why today you have six interest rates on the CETES—I think it is the 28-day CETES—that are at 60 percent right now.

Senator MACK. The point that you are making—maybe I might just ask Chairman Greenspan—do you think that message that there is going to be a continual printing of pesos in Mexico at 17, 25, or 30 percent is going to bring confidence back to the market?

Chairman GREENSPAN. Senator, I think it is very crucial that the central bank focus on trying to squeeze out the degree of excess liquidity in the system which has been built up in order to diffuse this inflation bubble which is emerging.

In other words, how do you address the situation that now exists?

With the sharp decline in the peso, you create a very large inflation bubble. That inflation bubble can be diffused and simmered down virtually to nothing and put behind you with the appropriate monetary and other policies.

If you fail, it sets the stage for an acceleration of inflation which basically will drag down the economic system.

What the policy problem basically here is, is to find the way to squeeze out the liquidity without breaking the back of the banking system concurrently, which is a very difficult thing to engineer.

The reason why this has gotten to be so difficult, is the issue of confidence has been allowed to drain out of the system. I do not

know what the particular policy would be that is required here to rebuild this. All I can say to you is, I think it is incumbent upon the Bank of Mexico to be creating severe pressure to remove as much liquidity quickly out of the system as possible—get rid of "spot pesos," if you want to put it that way, as quickly as is feasible in order to diffuse the inflation bubble.

The caveat is that, because of past policy mistakes, they have very little give in how far they can go without tiling over the banking system and other aspects of the economy.

I think, in principle, the issue is very clearly in the direction in which you are suggesting. Namely, to squeeze the system down and prevent the inflation bubble from extending itself. But I cannot tell you at this particular stage what that path is. I think you have to feel your way through it. It is tough enough to do it from up here. It is not all that much easier down there, I am sure.

Senator MACK. All right, I may have a series of questions to follow up on that point, but let me, if I can, just ask one more question that has to do with the political side.

How much consideration, and how significant do you think the "political situation" in Mexico is?

What I am referring to is, looking at the economic package—as much as I know about what it is and what has been agreed to—it seems to contain higher taxes and, as I think Secretary Kemp indicated this morning, a salary lock on minimum wage earners. From what I can tell, non-minimum wage earners can negotiate higher wages, but those earning the minimum wage cannot.

Given what has happened in Chiapas with the assassinations, what concern do you have with respect to how this whole political situation might boil over?

It sounds to me like there were two things, in fact, that caused this problem—one was the peso, and the other is the political situation—so what concerns do both Treasury and State have with respect to the political situation?

Mr. TARNOFF. Senator, I think without a doubt what President Zedillo asked of the Mexican people demands sharp sacrifices, as we read the program this morning.

But to answer your question briefly: We think he has several things going for him to continue to have political support. The fact that he was elected democratically is something that is accepted by his friends and his political foes, and that is important.

The fact that shortly after coming into office he made an unprecedented effort to bring together not only the ruling party but members of the opposition to agree on political reform we think has served his interests as well.

On Chiapas, there has been, of course, some uncertainty about the situation. But, here again, convening the Mexican Congress this week—which, as you know, has a fair representation of opposition as well as ruling party members so that the matter can be discussed openly—is something that is really unprecedented.

Finally, the fact that he has talked very openly in Congress and in the country about this economic program, including what the United States will provide, but more importantly what Mexico has to do for itself, indicates that he has done more than any of his

predecessors to include not only the members of the ruling party but the opposition in the country in this great debate.

For that reason, we think that not only is his personal standing high, which happens to be the case in the country, but he stands a very good chance of sustaining that support over time.

The CHAIRMAN. Senator Dodd.

Senator DODD. Thank you very much, Mr. Chairman.

Mr. Tarnoff, that is, I think, a very important answer you have just given, and I commend you for it. I would also point out that I think the principal opposition—and you made some suggestion of this—the Pon, which represents the more conservative business elements, if you will, in the country and did rather well, as you pointed out earlier, in a major gubernatorial race in the country recently, also I think is supportive of what the President is doing here.

Now, there will be some opposition to the left of Zedillo, but I think the major political parties in the country are supportive of what is going on here. So I think that is a critically important response to Senator Mack's question about the sustainability of what President Zedillo has suggested.

Mr. Chairman, I just wanted to make a couple of observations.

First of all, I must say, I believe the country is very fortunate to have this team that has worked on this issue. As pointed out by Senator Bennett and others, Bob Rubin, Mr. Summers, and others on the team have worked tirelessly on this and really deserve a great deal of credit.

This is a very delicate situation, obviously, but I think it is important to note that they are on the right track, we hope, and obviously you have both expressed the obvious reservations, because no one can say with absolute certainty what happens here. But I think your point about doing nothing, and the alternatives that would propose, are far more threatening.

I also want to underscore the points that have been made by Jack Kemp and others in reference to the Zedillo government. I have watched and worked with Mexico during my entire tenure here in the Senate. I have seen remarkable change—absolutely remarkable change—in the last 6 or 8 years.

There is still a ways to go, but for those who have followed Mexico over these years, we have seen change that was unimaginable—unimaginable—a few years ago. And there are a lot of people who deserve credit for that, but the fact of the matter is, this is a very different situation in Mexico today than was the case earlier.

I think it is important that we, while we have reservations about economic mistakes that are made—and Lord knows, we are not immune from that problem in this country, as we can certainly witness just by the good debates we have among ourselves here about the policies we make and the actions we have taken—the S&L situation, and I have great fondness for my colleague from Utah, but I think there the conventional wisdom was to do exactly the opposite of what we did, quite frankly. Whereas, in this situation you could make a case that conventional wisdom was not followed.

I would like to ask just one question, if I could, of the panel because it seems to me, again, I come back to the word "confidence." It is absolutely critical. If that element is missing here, it seems

to me what I have heard all of you say, in terms of the inflation bubble and the like, is if there is not some sense of confidence on the part of the people of Mexico and others, then a lot of what we are talking about here could explode. You could fulfill the self-fulfilling prophesy, in a sense, of an exacerbated and a more expanded problem.

What might we do here from the congressional standpoint, in your opinion, in order to inject some confidence into this process?

If we are going to be a partner and help to try to make this work, what should we be doing from the legislative side, or ought not be doing maybe, in order to see to it that we participate in this confidence-building process that all of you seem to indicate is the critical element to make this work?

I will start with you, Chairman Greenspan.

Chairman GREENSPAN. Senator, let's try to define really, in immediate terms, what we mean by "confidence."

In a market economy, a free society works because individuals trade with one another and have interpersonal relationships based on an issue of trust and an issue of law. That is, if you think for a minute how much activity goes on in any society on the trust of an individual that certain institutions will be in place, certain laws will be enforced, and certain people will behave in a certain manner, that is what makes the system work.

If you remove any element of that, the whole division of labor breaks down. It is crucially important for us to understand the actual mechanisms that confidence requires.

In that regard, and without responding directly to your question, I would break it down into the various constituencies. In other words, how do we basically construct or help to enforce and support a situation in Mexico in which foreign investors believe if they invest in Mexico that their rights are supported, that they have a judicial system which effectively adjudicates various different disputes, and that they have the capability of moving their funds in and out and exchanging them freely, because unless they have that general point of view, they will not deal in Mexico.

All I would suggest to you, Senator, is what we could do, and indeed try to encourage the Mexicans to do, is to create an environment in which people will want to do business because they think it is profitable and productive in that particular society.

Senator DODD. My time is about to expire. Let me get a quick answer from each of you on this.

Would legislation from the U.S. Congress that would annul the proposal that is on the table, in your opinion, undercut the very confidence we are trying to instill at this particular moment?

Secretary RUBIN. Senator, I think oversight, consultation, and hearings like this, where we can discuss differences of policy, are very constructive and contribute to the process.

I think legislation, or in fact the mere threat of legislation that would undo the program, could very seriously and adversely affect the market confidence and reduce the probability of success.

Senator DODD. Chairman Greenspan, do you agree with that?

Chairman GREENSPAN. Yes.

Senator DODD. Mr. Summers?

Mr. SUMMERS. Yes.

Mr. TARNOFF. Definitely.
Senator DODD. Thank you.
Thank you, Mr. Chairman.
The CHAIRMAN. Thank you very much, Senator.
Let me just follow up on that question of confidence. I teach a course—and I am not advertising about it——
[Laughter.]
It is called——
Senator SARBANES. Do not give an 800 number.
[Laughter.]
The CHAIRMAN. No 800 number. We have no room for any more students.
One thing I said to the class—and I don't know, but, Chairman Greenspan, Mr. Rubin, maybe you would want to comment—is that in order to have and attract investment, you must have political stability.
Would you agree with that?
Chairman GREENSPAN. Absolutely.
The CHAIRMAN. That is the one thing I tell them. I say, when I ask you on your final, if you do not give me that—everything else you can debate, but without political stability, it is risky.
When things get risky, interest rates rise. You pay more. There is a premium as it relates to risk.
Is that true?
Secretary RUBIN. Yes, sir.
The CHAIRMAN. Then I have to pose the question that I think both Senator Mack, and then my good friend Senator Dodd touched on:
How can we really, given what we know about the situation in Mexico—and I do not want you to beat up on the Government, but let us get into the real world here.
I have felt that now for the past 3 or 4 years, and it is important that I say three or four because I believe that the past Administration, as well as this Administration, has covered up basic information.
I think we were given a rosier picture of Mexico than really existed. I bought the myth of Mexico as this wonderful democracy, and this capital formation, and the bell weather for the emerging economies throughout the world.
And, again, I reiterate that this happened over at least 4 years, but certainly during the past 4 years, given what we see now and what is taking place in Mexico. And I do not mean Presidential statements. They do not mean a thing. These guys, they tell people anything.
They told people they would not devalue the dollar. They did it. Do you really believe that you will restore confidence just because America comes to the plate today with a very ambitious and well-intended program, that that will attract long-term foreign investment?
Do you think foreign investors will bet on stability, or put differently, invest when the stability that we have is in great doubt?
You send some troops in and you have choppers under consideration for the day. President Zedillo was able to go to Congress and bring some people in?

Do we really think that you will attract the amount of capital—and take a look at the medicine that is being administered. And, as it relates to our own relationship with Mexico, Mr. Secretary, the Secretary of State, the Mexican people—have you read the polls down there—are angry. And do you know who they are angry at?

Do you care to venture a guess?

You read Time Magazine. You also read the polls. Who are they angry at, Mr. Secretary?

Mr. TARNOFF. Some are angry at us, and some are unsettled by the situation in Mexico.

The CHAIRMAN. They are angry at the United States. They are blaming the United States of America. We are held responsible as the ugly banker for raising their interest rates.

How would you like to have a mortgage on your home with a 85 percent interest rate? From 20 percent to 85 percent? And what about all the other tales of woe?

They are really angry. And it is the Ugly American's fault.

Now, do you think this is going to create the kind of stability that will encourage economic investment? If you shovel enough dollars in there, you can shore up the peso for a little while.

But, I have to ask another question.

When the going gets really tough, do you believe that the central bank—I heard a lot when we were discussing with them whether the central bank is independent of the government—I guess the central bank is still independent of the government, isn't it, Mr. Summers?

Mr. SUMMERS. Yes.

The CHAIRMAN. Then, what will prevent the central bank from just printing more pesos?

Isn't this a question that people have a right to ask if you are going to spend $20, $30, or $40 billion?

I do not feel confident in the stability of the Mexican government. Now, if by saying that I somehow create—oh! I shouldn't say it!? I'm the Senator. I'm the Chairman of the Senate Banking Committee.

Are we in a make-believe world? Given the events that have brought us to today, given today's situation down there, I think you have to be a fool to think that you would be investing in a stable situation.

Secretary RUBIN. Could I respond, please, Mr. Chairman?

The CHAIRMAN. Please.

And maybe you will come to lecture at the class.

Secretary RUBIN. Oh, lecture at? Because you said there was no more room for students.

The CHAIRMAN. Oh, no, no. Just to lecture.

Secretary RUBIN. I was prepared to come as a student, but if you prefer——

The CHAIRMAN. This is not open to the public. There will be no media.

[Laughter.]

Secretary RUBIN. Oh? OK. There may be a fee question, but we can work that out.

The CHAIRMAN. Oh, no fee.

[Laughter.]

Secretary RUBIN. OK, that reduces my incentive. But, OK.
[Laughter.]
The CHAIRMAN. Very good.
Secretary RUBIN. I did not work on Wall Street for 26 years for nothing.
[Laughter.]
I wrote these down. I think I saw it as five questions.

In terms of the kinds of discussions we have just had and your views, I think it is very, very important that we have these kinds of dialogs. I really do. I think we all work our way through this stuff together. So I think that is a very important thing.

In terms of the myth, Mr. Chairman, I would like to identify with the comments that Chairman Greenspan and Under Secretary Summers made: They clearly made some very, very bad financial decisions in 1994, but I also think it is true that there were enormous accomplishments—and I guess Senator Dodd said the same thing—enormous accomplishments over the last 6 years, or I think it probably went back beyond that 6 years to the prior Administration, which has made Mexico a very different country today than it was 10 years ago, or even 5 years ago.

It is that very different set of fundamentals that in our judgment creates the prospect that Mexico could once again be a major trading partner.

In terms of their telling people anything and then doing what they want to do, No. 1, I believe they will follow through on what they are saying. I may be right; I may be wrong. You are absolutely right. One can only tell after you watch.

It is for that precise reason we structured the program in the way we did. What we do is, we disperse these funds in tranches. The tranches are conditioned on their continuing to do what they are supposed to do, what they themselves say is in their self-interest, and what we certainly believe is in their self-interest. In fact, even after the tranches are fully dispersed, in the way that we have constructed this, they still have very heavy pressure under these agreements to live up to the commitments they have made.

In terms of the central bank itself, you raise a point, Mr. Chairman, that we think is central to this whole enterprise. We have spent endless hours on the issue that you have raised, and very rightly raised.

It is because we want as much assurance as we can get that we have insisted on transparency and the weekly reporting of monetary figures. That will give us the opportunity to monitor this as we go along.

As to the Mexican people themselves, I think, Mr. Chairman, that it would be understandable for them to be upset and angry at a lot of people, given the circumstances that they are in, but there is no question in our minds of two things.

No. 1, that the Mexican government has made the decisions to follow this tough path.

And, No. 2, that over time the Mexican people will be far better off on this path than they would with default and the consequences that would flow therefrom.

The CHAIRMAN. Thank you, Mr. Secretary.
Senator Sarbanes.

Senator SARBANES. Thank you, Mr. Chairman. First, I have the question of one side, but I just want to ask a question about the falling dollar about which we are hearing so much.

It is my impression, and I would like to be corrected if I am wrong, that the falling dollar is against the mark and the yen, but that the dollar is doing quite well against other currencies.

Is that correct?

Chairman GREENSPAN. The trade-weighted exchange rate, which covers most of our trading partners, is down, but it is down significantly less than it is for the yen and the Deutschemark. Obviously, with major trading partners such as Mexico and Canada whose currencies have weakened vis-a-vis the U.S. dollar, you have had a general offset, but we are still down relative to the total mix.

Senator SARBANES. Is the amount by which we are down in the trade-weighted average explained by the decline in the Deutschemark and the yen?

Chairman GREENSPAN. Not wholly, because remember that most of the European currencies, while falling relative to the Deutschemark, have still nonetheless risen relative to the U.S. dollar. So it is largely a European, but not necessarily wholly, a Deutschemark issue.

Senator SARBANES. I am not sure that gave me the answer to my question.

Chairman GREENSPAN. The dollar is lower vis-a-vis the French franc, the Swiss franc, in fact——

Senator SARBANES. If you took out the Deutschemark and the yen from the basket, would the dollar be up or down?

Chairman GREENSPAN. I do not know the answer to that. I would have to do the calculations. It is a close call.

Senator SARBANES. Now let me ask a question about the use of the Exchange Stabilization Fund. A question was raised earlier today about how much was left to intervene, and so forth.

I take it, though, in the use of that Fund there is some concern about immediately revealing or reporting the timing and the amounts of interventions.

Is that correct, or not?

I know you are required to report. As I understand it, it is 30 days after the end of the month in which a transaction occurs. So there may be as much as almost a 60-day period before you report on what was done.

I take it contemporaneous reports as to timing and amount would have problems associated with it.

Is that correct?

Secretary RUBIN. Senator, I think it is absolutely critical with respect to interventions that the market not know what we are doing when we are doing it: (a) that we be able to move immediately; and (b) that the market not know what we are doing when we do it. So it is, I think, critical that the reporting requirements be designed to respect those two needs. Therefore, the answer to your question is: Yes.

Senator SARBANES. I would like to just close with a couple of observations, Mr. Chairman.

First of all, I think it is clear there is a fine line that has to be walked when you are dealing with a situation that involves the res-

toration of confidence factor about which Chairman Greenspan in particular, but the others too, have made extended reference to this morning. That is, a fine line between a careful examination of the situation and the policy options available—how did it arise, what were the choices, what should we be doing now, what are the predictions for success—and overstated criticism which may in and of itself become self-fulfilling.

There is no magic prescription to that, but it seems to me all of us involved in this process have to be sensitive to it.

The fact is, the overstatements can in fact impact upon the confidence question in a way that impacts, conceivably can even transform, a situation that may have been working in a positive direction turning it into a negative direction. That seems to me to be a legitimate concern.

I do not have a magic answer to the problem, but I think the first step at trying to arrive at some rational answer to it is to recognize that there is such a problem.

I wondered, Chairman Greenspan, whether you would agree with that perception?

Chairman GREENSPAN. I think it is a very difficult problem because, ultimately, confidence is not based on people's psychologies; it is based on the real world.

Senator SARBANES. Right.

Chairman GREENSPAN. What the real facts are; not perceptions.

The CHAIRMAN. Right.

Chairman GREENSPAN. At the end of the day, perceptions wash out and reality asserts itself. The issue that is a subtle and difficult one to deal with is at what point do you stray over the line and create real problems? Because arguing from the other side, from another point of view, it is very easy to delude yourself. It is one of the more difficult things that I think policymakers who are involved with markets have to deal with.

You cannot fool the markets ultimately. There is a real world out there, and events will happen. But there is no question that on occasion you do get aberrations where somebody in the market says something and it sets off a set of circumstances which are difficult to reverse. And I do not know where to draw the line on that.

All I can say is it is a difficult one to deal with, and I think each of us has to make a judgment as to where we are endeavoring to identify reality, and where we are going overboard.

Senator SARBANES. Secretary Rubin?

Secretary RUBIN. Senator, I think I will identify to some extent with what our unpaid consultant had to say.

[Laughter.]

Chairman GREENSPAN. The "unpaidness" reduces a great deal my incentive——

[Laughter.]

Secretary RUBIN. We could negotiate with each other for a long time.

[Laughter.]

Obviously, in the long run, it is reality that will determine what happens. I totally identify with that.

I also totally identify with the notion that it is important to have a healthy and candid debate, as I think we have had in this hear-

ing, for example, on the policy issues—this hearing today—that relate to this matter.

On the other hand, it is also true that, in the shorter run, I believe there are serious issues of perception and psychology, and that psychology can be affected by the things people say.

So I think it is very important that people, on the one hand, have a healthy debate, and, on the other hand, be cognizant of the effects that things they say have on markets, because markets do react to what they hear—particularly what they hear from people in positions to affect events.

Senator SARBANES. Yes. I have been in hearings where Chairman Greenspan has made a comment and half the room has emptied as they scrambled to get to the telephones in order to impact on the market on the basis of some comment he just made which was designed for no one to really understand its import.

[Laughter.]

Secretary RUBIN. At which he is a master, Senator.

Senator SARBANES. Yes.

The CHAIRMAN. Senator Dodd.

Senator DODD. Very, very briefly, just let me second the comments of my colleague from Maryland.

Also—I should have made note of this at the very outset—I want to commend Senator Dole and Speaker Gingrich on the statement that they made back on January 31, 1995. It was a very, very important statement they made at the time to endorse the actions of the Clinton Administration.

Again, with a full understanding that this was not an absolute guarantee of success, but I think with a full appreciation of the fact that this needed strong bipartisan support, the President needed to act.

I have said this in the past, I think it is important in these matters that Congress be involved whenever possible. It is so important, as a co-equal Branch of Government, that we be a part of that mix.

I am saddened that, for obvious realities, that was not going to happen. So we had to proceed the way we have. But without the statements of Senator Dole and Speaker Gingrich, I think it would have created some problems.

I commend them for those comments.

I want to just quickly come back, if I can, Chairman Greenspan, to the Balanced Budget Amendment.

As you stated, you were opposed to that particular approach. Do you think it had more to do with the anticipation of that amendment being adopted?

You made note of the fact that real deficit reduction, which had occurred during the last couple of years, had generated a certain amount of very positive reactions in the marketplace.

I think what I heard you saying—and you can expand on this—is that the defeat of that particular constitutional amendment and its anticipation of passage may have triggered some activity. But what is critically important is that we really engage in some continued real deficit reduction. That that is the reality.

Is that not true?

Chairman GREENSPAN. I certainly agree with that.

I think the Balanced Budget Amendment vote was a symbol of concerns that the financial market has that we are not serious about coming to grips with this chronic budget deficit which has been festering for a long time and creating real, serious problems with, as I said before, our current account deficit.

I do not think it is the issue of the Balanced Budget Amendment, per se, but the symbolism that the vote was essentially saying that this Government is not serious in trying to address the deficit.

I think the reason the markets respond the way they do is that there is a general awareness that the capability of going indefinitely with these types of deficits has limits to it.

As I said before, I must say my impression is that there is a real, basic desire on the part of this Congress, more than at any time I have seen in the last 20 to 25 years, to finally come to grips with this issue.

I am perhaps more optimistic about it than I should be, but I cannot help responding to the tone that one senses on both sides of the aisle in both Houses.

Senator DODD. That is encouraging. I think I agree with you on that. But the point is, had you been a sitting Member of the U.S. Senate, would you have voted against that constitutional amendment?

Chairman GREENSPAN. I am not a sitting Member of the Senate, and consequently do not have to make that judgment.

[Laughter.]

Senator DODD. Keep trying. Keep trying.

Last, I just want to, if I can—Senator Bennett asked for the response to Jack Kemp's questions. I hope that will be made available to all of us. I think they were good questions, and I think he addressed it to you, Chairman Greenspan; but, Secretary Rubin, I would like you to respond to them as well, for the Treasury to respond.

I would like to get some copies of those, if you could, as soon as you can. I think Jack asked some very good questions. It is an alternative proposal and——

Chairman GREENSPAN. Let me say this. He is raising, I think, very important questions.

Senator DODD. I agree.

Chairman GREENSPAN. Serious answers are required, and I think it is not a clear-cut case. It is very important that we focus on this and try to find some consensus, if such can exist.

Senator DODD. I agree with that totally. That is why I think it is important to get them, and I would like to see them myself. I am sure other Members might, as well.

Again, I thank all of you for the job you have done. You have served your country very, very well.

Thank you, Mr. Chairman.

The CHAIRMAN. In an effort to give a little balance to Senator Dole's position, I am going to ask that a letter he sent today to Secretary Rubin be included in the record, but let me take the time to just read a part of it.

He reflects:

On January 31, 1995, in an effort to avoid complete financial collapse in Mexico, I participated with other congressional leaders in a statement supporting the Presi-

dent's use of the ESF. However, this expression was not intended and should not be construed to convey my blanket support for the underlying policies of the Administration or for the economic and legal agreements implementing those policies.

To the contrary, I reserve these judgments.

I have since cautioned the Administration to be careful in its use of the ESF, and I have expressed deep reservations about the shortcomings of the agreements.

He goes on to say:

My good-faith efforts in January to cooperate with the Administration in no way should be interpreted as any protection from legitimate and responsible congressional oversight. Congress and its Committees have every right, and the constitutional duty, to examine thoroughly the Administration's conduct and policies toward Mexico, and certainly to oversee the expenditure of billions of dollars in taxpayers' funds.

He goes on to say he supports the efforts of the Banking Committee in terms of this exercise.

He then includes an attached statement, that he made on the Floor of the Senate, February 24, 1995, and I am going to read part of it.

He says:

The Treasury needs to be very careful in the use of funds from the Exchange Stabilization Fund. For example—I am not convinced that thrusting the United States into the middle of a Mexican banking crisis is prudent or necessary.

I would suggest that if indeed these dollars are used to bail out the banking system, then that is a problem for some of us. We have to know why, how, et cetera.

The primary focus of the stabilization plan is not aimed at reversing the fundamental mistake of devaluation, not now and not over time.

I think you have heard an undertone both by Secretary Kemp and by some of the Members here, certainly Senator Bennett and Senator Mack, that the measures described in the agreement to firm up the price of the peso seem almost an afterthought. They do not address the problem of extinguishing the excess pesos that have been coming off the Mexican printing press, even as recently as last week.

The heart of the problem is restoring confidence in Mexico by restoring the value of the Mexican currency. I hope it is not too late, and I hope the Administration's officials will focus on the main target of extinguishing pesos and restoring confidence in the Mexican currency.

This should be the first priority, not raising interest rates.

He goes on. I stop there, but these are very serious questions.

I would like to just touch on a couple of questions.

Mr. Secretary, how much money have we pledged and/or dispersed to date?

Secretary RUBIN. I would like, by the way, to comment on these two documents at some point.

The CHAIRMAN. Certainly.

Secretary RUBIN. But let me respond to your question first.

There is presently outstanding approximately $2 billion of short-term swaps with Mexico which will remain outstanding. And we have authorized the disbursement—which I mentioned in my opening statement—of the $3 billion first tranche to Mexico which will be used solely for the purpose of dealing with short-term debt of the government of Mexico.

The CHAIRMAN. Now, that $2 billion in swaps, does that come from the ESF?

Secretary RUBIN. One billion dollars of it came from the ESF, I believe, and $1 billion from the Federal Reserve Board.

The CHAIRMAN. Concerning the $3 billion, you say it will be used for the public debt.

Secretary RUBIN. Correct.

The CHAIRMAN. Does that mean the Tesobonos?

Secretary RUBIN. It could mean Tesobonos, or it could mean other public debt; that is correct.

The CHAIRMAN. So now what will we do? Will they reclaim these Tesobonos?

Secretary RUBIN. There are a number of ways that, technically, they might act, but the effect of it would be to either retire or stretch out the debt, the public debt.

The CHAIRMAN. Do we know how they are going to do that? Do we know what kind of plan they will implement as it relates to reclaiming or paying off that debt as the Tesobonos come due?

Secretary RUBIN. You mean, technically, how they are going to do it?

The CHAIRMAN. Yes.

Secretary RUBIN. They have a number of choices, and I think really, Mr. Chairman, that is a decision that they, with their advisors, J.P. Morgan, would presumably make at the time in terms of what is best for them, just as we make our decisions at the Treasury with respect to various refunding in the United States in terms of the circumstance of the moment.

The CHAIRMAN. Except that I would again suggest that we have a very direct interest because these are dollars coming from our Treasury. So we are not just a third party talking to a sovereign country that could say to us, "Hey, wait a minute, what are you doing here?"

Secretary RUBIN. Mr. Chairman?

The CHAIRMAN. If you are taking my money, or if we are making it available, we have a right to have certain conditions.

I would like to know, and you probably do know, or someone should know, how those Tesobonos will be repaid?

Are they receiving dollar-for-dollar, plus all the interest?

Secretary RUBIN. As they go along and do this, they will obviously be in very close consultation with us. We will know absolutely what they are doing and why they are doing it.

The CHAIRMAN. I mean, do you think it is a fair question?

Secretary RUBIN. Yes. Oh, no, absolutely it is a good question.

Mr. SUMMERS. Senator, it is anticipated that the Mexicans will meet their obligations in full on Tesobonos.

The CHAIRMAN. How much in Tesobonos is outstanding?

Mr. SUMMERS. Between $17 and $18 billion, down from roughly $30 billion at the beginning of the year.

The CHAIRMAN. There is something called "Eurobonds." Are you aware of those?

Mr. SUMMERS. Sure.

Secretary RUBIN. Of Eurobonds?

The CHAIRMAN. Yes.

Secretary RUBIN. Sure.

The CHAIRMAN. Mr. Summers?

Mr. SUMMERS. I am aware of Eurobonds.

The CHAIRMAN. Do you know how many billions of dollars in Eurobonds the Mexican government has outstanding? Do they have any Eurobonds outstanding?

Mr. SUMMERS. They do have outstanding Eurobonds. I do not have that number right here. We can certainly furnish that information.

The CHAIRMAN. Do you know who holds those Eurobonds? Is it possible to find out?

Someone is shaking his head "no." I guess he is one of your counselors.

Mr. SUMMERS. I do not know to what degree those securities are registered, and it is possible——

The CHAIRMAN. OK. Could you find out approximately how many billions of dollars in Eurobonds Mexico has outstanding?

Mr. SUMMERS. I would anticipate, yes.

The CHAIRMAN. Does the agreement in any way affect the repayment of those Eurobonds? Do you know when those Eurobonds become due? Do you have a schedule?

Mr. SUMMERS. The Mexican government does, and has furnished that information to us. I do not have that in front of me.

The CHAIRMAN. Mr. Summers, I do not want to be argumentative, but it boggles the mind that you would spend billions of dollars if you did not fully know and have a detailed understanding of the magnitude and types of public obligations for which you might be asked to extend credit or give a guarantee.

Now, is that not true?

Secretary RUBIN. Mr. Chairman, let me assure you, we know exactly what their outstanding obligations are, and we can give that to you in writing if you would like.

The CHAIRMAN. OK.

Mr. Secretary, the reason I say that is because if we are going to be candid and forthcoming, and it does not have to be at hearings, why then I need that kind of assurance that you have given me, and not Mr. Summers saying, "Well, you know, there may be Eurobonds"—there is about $8 or $9 billion worth, is there not?

Mr. SUMMERS. Excuse me, Mr. Chairman. We have that information. I just did not have that information right here.

The CHAIRMAN. Oh, OK. All right.

Mr. SUMMERS. We will be happy to make that information fully available. Absolutely.

The CHAIRMAN. I do not want to micromanage, but I would like to get the scope of the problem.

Secretary RUBIN. Mr. Chairman, we would be delighted to provide you with anything you would like. I have had a lot of experience working with economists and people working on complicated projects. Treasury has the good fortune of having an extraordinarily capable team, and so do our consultants, and we can give you all of the information that you would like, and whatever analysis of it you would like.

The CHAIRMAN. Good.

Secretary RUBIN. And we would be delighted to meet with your staff, if you would like, and really spend as much time on this as you would like us to.

The CHAIRMAN. We have a number of other questions, but I wanted to say I think this has been a very constructive hearing. I am pleased by the manner in which, Mr. Secretary, you have offered to make available to us the indexed information that I have requested. I think that is important. That makes it possible for us to meet our oversight responsibilities.

That indeed is important, and I think it is time. Senator Bennett asked, "Can we learn from previous mistakes?" We will be in a position to do a better job. So it is in this spirit that I raise again—and I do not mean to prolong this hearing because it is after 2 p.m.—my basic concerns. I hope that this does not anger people. With regard to the stability of Mexico, and whether Mexico can—and by the way, I do not realistically understand how Mexico can carry out some of the programs they are implementing without causing tremendous unrest and problems.

I think it is unrealistic to believe Mexico can continue its austerity program for an extended period of time and sustain the action necessary to restore investor confidence in Mexico.

That is my concern. Other people obviously may disagree. I hope I will be wrong.

Senator Sarbanes.

Senator SARBANES. Thank you very much, Mr. Chairman. There are some matters I want to submit for the record in light of the testimony yesterday and, to some extent, some of the questioning today, although it is primarily from yesterday.

Some assertions have been raised that the Federal Reserve and the Treasury sought to end-run Congress by using the Exchange Stabilization Fund. I think it is important that the record show, first, that the Treasury and the Federal Reserve came to Congress to seek congressional authorization for a loan guarantee package for Mexico. That was the initial approach.

The loan guarantee package was endorsed by the congressional leadership, both Republican and Democratic. On January 12, 1995, a joint statement was issued by the President and the congressional leadership which said in part:

> We agree that the United States has an important economic and strategic interest in a stable and prosperous Mexico. Ultimately the solution to Mexico's economic problems must come from the people of Mexico, but we are pursuing ways to increase financial confidence and to encourage further confidence in Mexico. We agree to do what is necessary to restore financial confidence in Mexico without affecting the current budget at home.

I would like to submit that statement for the record.

That was followed by extensive consultations between the Treasury, the Federal Reserve, and Members of the House and Senate to craft a package that could win congressional approval.

A January 14, 1995 article in the Washington Post reported:

> . . . Treasury Secretary Robert E. Rubin and Federal Reserve Chairman Alan Greenspan canvassed Capitol Hill, briefing legislators on the details of the plan and lobbying for support. . . . at the close of a 2-hour meeting, House Speaker Newt Gingrich (R–GA) told the gathering that the Republican leadership in the House stood firmly behind the Administration's rescue plan.

'We have zero choice on this,' he said, according to those who attended the meeting. 'The Republican leadership,' he added, 'is committed to doing everything we can to make it work.'

And I would like to submit that article for the record.

There then followed 2 weeks of extensive efforts by the Treasury, the Federal Reserve, and congressional leaders to craft a package.

An article in Roll Call on January 19, 1995, commenting on this effort, said:

Not only did House Speaker Newt Gingrich (R–GA) and Senate Majority Leader Bob Dole (R–KS) immediately back President Clinton in offering a $40 billion loan guarantee to Mexico, but House and Senate task forces have been working tirelessly with the Administration and Mexican officials to craft legislation to put the guarantee into effect.

Now, as we know, that, in the end, never happened. The "Financial Times" actually reports about a conversation between Panetta and Gingrich that took place at the end of January:

The message from Gingrich was simple and pessimistic: Congress was objecting to the loan guarantee package, and the chances of its rapid and successful passage were slim and worsening.

According to the article, Speaker Gingrich told Panetta:

It would take at least another 2 weeks to line up support for the package. If the President acted on his own, Congress would breathe a huge sigh of relief.

The decision was then made, according to this article, to move away from the loan guarantee proposal and to develop a new support package centering on financing from the Exchange Stabilization Fund.

On January 31, 1995, a joint statement was issued by President Clinton, House Speaker Gingrich, Minority Leader Gephart, Majority Leader Dole, and Minority Leader Daschle. That statement said in part, and I quote:

We agree that in order to ensure orderly exchange arrangements and a stable system of exchange rates, the United States should immediately use the Exchange Stabilization Fund to provide appropriate financial assistance for Mexico.

We further agree that under Title XXXI of the U.S. Code, Section 5302, the President has full authority to provide this assistance. Because the situation in Mexico raises unique and emergency circumstances, the required assistance to be extended will be available for a period of more than 6 months in any 12-month period.

And I would like to submit that full statement for the record.

I would also like to submit two articles, one from Reuters on January 31, 1995, which stated:

Dole said he had checked with other Senators, including some who had opposed Clinton's request for $40 billion in loan guarantees for Mexico, before deciding to write the letter. 'In my opinion, most everybody's on board supporting Clinton's new plan to instead commit $20 billion from the U.S. Currency Exchange Stabilization Fund,' Dole said.

A New York Times article of February 2, 1995, quoted Speaker Gingrich as follows:

'The President exercised his authority,' Mr. Gingrich said today. 'He took a tremendous burden on his shoulders. He did what key leaders have felt was necessary.'

The point I am trying to make here is that, while people may disagree with the policy of providing assistance to Mexico, or the policy of providing it from the Exchange Stabilization Fund—and it is important, of course, for Congress to carry out its oversight responsibilities—I do not think it is accurate that Treasury and the Fed-

eral Reserve did not consult with Congress or seek congressional approval of their policy.

In fact, I think they made a rather extraordinary effort. I do not recall any time in which Chairman Greenspan visited the Hill as frequently and as intensely as took place during this period with respect to a policy matter.

I also want to close with these observations.

Some have raised the question that the use of the Exchange Stabilization Fund to provide assistance to Mexico was beyond the statutory authority of the ESF.

I have reviewed legal opinions that have been written on that matter, both by the Counsel to the Treasury Department and also by the Assistant Attorney General in the Justice Department, upholding the legal authority to use the ESF to assist Mexico.

Therefore, it is my view that the Administration has worked completely within its legal authorities. Now, this does not go to the question of whether someone wants to differ with the policy; I just want to get at the question that the action taken was within the legal authority.

Second, it has been suggested that Treasury has not reported appropriately on the use of the ESF. The statute which requires the reporting requirement, in my perception, has been completely complied with by the Treasury.

It is my understanding that very extensive additional requests for documents have been made to the Treasury by Members of Congress far exceeding the reporting requirement contained in the ESF legislation, and that Treasury has complied with most of these requests and is seeking to deal with them.

I just want to point out that there is an important distinction between Treasury meeting its statutory obligation to report on the ESF, which has been done in full, and responding to requests from Members of Congress that go well beyond that, where appropriate judgments have to be made about the provision of classified and internal documents.

I understand there is an exchange of correspondence between the Chairman and the Secretary on this issue, and I would like, Mr. Chairman, for that correspondence to also be included in the record in order to address this question of how forthcoming the Treasury has been in response to requests for documents.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Before I call on Senator Bennett, let me indicate that this Senator has never questioned whether the funds of the ESF could be used for the purpose they were established.

I would also point out that, in a letter or in an opinion from the General Counsel to the Treasury, it is worth noting, on page 6 the second paragraph, he says that:

> Although loans and credits are clearly permitted under the ESF, their purpose must be to maintain orderly exchange arrangements in a stable system of exchange rates, and not to serve as foreign aid.

Let me suggest, and I do not intend to pursue this matter but I do believe that, if one were to look carefully as we go down the road, there may indeed be occasions where we are going far beyond even what that opinion says you can do.

Now, I do not want to begin debating about whether making loans to government authorities or making monies available in the country constitutes foreign aid as opposed to the specific purposes for which the ESF was set up, but I do think that is a significant question.

Second, in addition to the statutory language as it relates to the requirements of Treasury to make available certain information in an orderly reporting fashion, this Committee has absolute authority to request from various agencies, and in this case from Treasury, information necessary to fulfill our oversight responsibilities.

I hope we will be able to deal with that situation in an amiable manner. We do not intend to challenge the status of classified documents or information. We will see to it that only those people with proper security clearance handle those documents. I hope that we can work that out.

Executive Privilege has not been asserted. I hope that we never reach that point. I look forward to working cooperatively with the Secretary in finding the kind of information that I have mentioned today.

How much money?

What types of obligations?

What will we see down the road?

I think the American people have a right to know. I am encouraged by the response of Secretary Rubin and Mr. Summers today.

Yes, Mr. Secretary.

Secretary RUBIN. Let me, if I could, Mr. Chairman, just comment on the matter you just raised.

Let me try to frame it this way: We would be delighted to meet with your staff and to provide you with all the information that we have on the program. We are now working to try to give your staff a full understanding of everything relating thereto, including our thinking.

I think there are issues, and I hope we will be able to work this out, with respect to the documents from the past couple of years. We have given you all the documents that we know of from 1994 relating to Secretary Summers and Secretary Bentsen.

There is the question of a chilling effect, as you produce more and more documents from more and more junior people, in terms of our internal functioning——

The CHAIRMAN. No, we are not going to attempt to do that.

Secretary RUBIN. OK.

The CHAIRMAN. I think we can——

Secretary RUBIN. And that is what we want to work out in a constructive fashion.

The CHAIRMAN. We are not going to bury you with paperwork, et cetera. You know, basically, where we are going, the areas we are concerned with. We have expressed them here today.

We are not interested in the phone logs, et cetera, and all of the junior people who have been involved in this.

Secretary RUBIN. I am confident, Mr. Chairman, we will be able to work this out.

The CHAIRMAN. I am, too.

Secretary RUBIN. Good.

The CHAIRMAN. Senator Bennett.

Senator BENNETT. Thank you, Mr. Chairman. I was a little surprised when I came back from my speech to discover you were still here.

[Laughter.]

I was hoping you would not be.

Senator SARBANES. You may be able to go give another speech and come back.

[Laughter.]

Senator BENNETT. I am sure the witnesses are hoping that we will not still be here.

I just have one question that I did not pursue last time. Former Chairman Volcker made the statement that, given my orientation, I grabbed onto when he said, "As soon as you get a stable currency, long-term interest rates will start to come down."

I am assuming from your nods you agree with that. Again, given the exchange we have had, I will not beat the point, but I would hope we would have as one of our number one priorities here to do something that will produce stable currency.

I would like to see it stabilize somewhere above the 7.45 that it closed at yesterday, but whether we can get it back to 5.5—I remember when we first started this, people were saying, "Well, it is going to have to stabilize at 5.5, Senator. You cannot get it anywhere near there."

Five point five would look like nirvana at the moment. And if we can stabilize it somewhere and make that a primary focus, then the long-term interest rates are going to come down.

Mr. SUMMERS. Senator Bennett, from that perspective, I think we take some encouragement that the peso is now at 6.25, which represents a very substantial improvement from where it was yesterday.

Senator BENNETT. That is an improvement from what it was when the hearing began. Maybe if we stay in session——

[Laughter.]

Mr. SUMMERS. It is a costly way to produce that.

[Laughter.]

Senator, I think that the issues you have raised are absolutely central. I think we are all in agreement, and economists of a wide variety of persuasions are in agreement, that what is needed here is limits on the number of pesos that are going to get printed so as to have a situation where the peso remains stable in value, and where, in the context of that stability, interest rates fall.

On those three points, I think there is no disagreement of any kind across a wide spectrum of opinion. Any disagreements go to the question of the precise tactics of how it is that that takes place.

I have one statistic which has not been pointed out in this hearing that I think you may feel you can take some comfort from. It is difficult to interpret because there is a lot of seasonality in Mexican data, but the money base of Mexico, the supply of outstanding pesos, has fallen by 7.4 billion pesos since January 1, 1995; and it has fallen by an additional 1 billion pesos since February 20, 1995, according to the data that the Mexicans have made available.

Now, I do not want to over-interpret that because there is a normal tendency in Mexican data for the money stock to decline during the first quarter of the year, but I think that is suggestive that

the tightening of credit conditions in Mexico which they have committed to is having some substantial positive impact.

Senator BENNETT. I will review it with great interest.

Does anyone else want to comment?

[No response.]

Otherwise, let's go eat.

Senator SARBANES. Mr. Chairman, could I just——

The CHAIRMAN. Senator Sarbanes.

Senator SARBANES. I would like to put in the record—I do not think I asked to do so, although I made reference to these legal opinions—since you quoted it in part where it said:

> Although loans and credits are clearly permitted under the ESF, their purpose must be to maintain orderly exchange arrangements in a stable system of exchange rates and not to serve as foreign aid.

Which is the question that was raised.

But the opinion then went on to deal directly with that question by saying:

> Therefore, in all swap transactions, Treasury has taken steps to assure that there is a source of repayment of the ESF. For example, ESF-swap arrangements have frequently been tied to an IMF stabilization program with drawings on the ESF bridged to drawings on the IMF.

Then it goes on to talk about the sources of payment for the Mexican loans and guarantees that have been developed:

> Proceeds of the Mexican oil sales—the United States is also requiring Mexico to maintain the value of the pesos that it provides under the medium-term swap as a further measure of protection.

So it is a legitimate issue to be raised, but it was raised in the legal opinion and then dealt with, and I would like that opinion—that is, the one from Treasury—and also the opinion from the Department of Justice, from the Assistant Attorney General, included in the record, along with the other material that I indicated.

The CHAIRMAN. So ordered. All of the documents which Senator Sarbanes has asked to be included in the record will be included in the record as if read in their entirety.

Gentlemen, we thank you for your participation and for your patience. I think the hearings were informative, and we look forward to continued cooperation.

We stand in recess.

[Whereupon, at 2:30 p.m., the hearing was adjourned.]

[Prepared statements and additional material supplied for the record follow:]

PREPARED STATEMENT OF PAUL A. VOLCKER

FREDERICK H. SCHULTZ PROFESSOR, INTERNATIONAL ECONOMIC POLICY, PRINCETON UNIVERSITY; CHAIRMAN, JAMES D. WOLFERSOHN, INC., NEW YORK, NY; AND FORMER CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, WASHINGTON, DC

MARCH 10, 1995

Mr. Chairman and Members of the Committee, as you know, I have been asked to appear before you on short notice, and I have no extended written statement. I trust I can be most helpful at this stage by setting out a few general points that seem to me relevant to the policy of the United States in response to the difficult situation in Mexico and the use of the Exchange Stabilization Fund.

My first point is basic. Whatever the arguments and questions about the specific approaches taken, the United States has had, and continues to have, a strong national interest in providing transitional financial support to Mexico as it struggles with a major financial crisis. We have a large stake in the growth and stability of our large southern neighbor. That is true because a prosperous neighbor is likely to be a friendly neighbor. Mexico provides markets for our producers, competitively priced goods for our consumers, and profitable opportunities for investment. Improved prospects for political stability and harmony are plainly good for the United States as well as Mexico.

More than that, Mexico has adopted outward looking economic policies in recent years, better developed its internal markets, encouraged private enterprise, and worked toward restoring monetary stability. In doing so, it has provided a promising model for other emerging markets and developing economies in Latin America and elsewhere. Obviously, serious mistakes have been made in the process, mistakes not just by Mexico but by American and other investors who showered the country with more money at shorter term than could easily be managed. A heavy price is being paid for those miscalculations, most immediately in setting back—way back—the remarkable progress that had been made toward price and financial stability.

What's important now is that a new base be laid for restoring that stability, while preserving and reinforcing the structural economic changes that seemed so promising only a few months ago—and which remain so today.

Given the severity of the shock, and the blows to the confidence of Mexicans themselves as well as to foreign investors, it is vitally important that that renewed base for growth and stability be laid as rapidly and convincingly as possible.

Given the sudden absence and reversal of voluntary private financing from abroad and the pressures on domestic financial markets, the necessary changes in policy and economic adjustments cannot realistically be made effectively and with reasonable speed without a backstop of external support.

We can argue about the nature and size of that support, the relative responsibilities of the United States, other countries, and the IMF and other multilateral institutions. What cannot, in my view, be disputed is that it was appropriate for us to act, and act with dispatch.

That brings me to my second point. With the size and power of the United States go both important opportunities and heavy responsibilities. The first responsibility is, of course, to ourselves—to maintain our own strength and stability. But to a greater extent than other nations, we can influence the kind of world in which we live, and especially the policies and prospects of our trading partners.

In that context, any American Administration must have readily at hand both the authority and capacity to react fast and effectively to sudden threats to external financial stability and to the kind of open economic order upon which we are dependent.

Typically, those threats are not predictable in timing or magnitude. That is why, for many years, the financial resources available in the Exchange Stabilization Fund have been so useful and, at some critical points, essential. Those resources were provided by Congress some 60 years ago in the aftermath of the international financial debacle of the early 1930's. They have, in my experience, been used sparingly and prudently. That includes a number of occasions during the Latin American debt crises of the 1980's, typically in conjunction with other financial authorities and paralleling assistance by the IMF. I have no doubt, along with the so-called swap facilities of the Federal Reserve, the availability of the ESF was essential to containing that earlier crisis and avoiding a systemic crisis in international banking.

To be sure, present arrangements with respect to Mexico are without precedent in size and nature. But it is also true that those arrangements were only put in place after consultation with (and, as I understand it, the acquiescence of) bipartisan congressional leadership.

Surely, this Committee is justified in carefully reviewing the approaches taken in this crisis, and achieving full understanding of the precipitating events and the responses to them. What would be inappropriate, as I see it, would be to either attempt "micro-management" of the use of the ESF, or to so constrict its future use as to render it ineffective in the face of future crises—which, if history tells me anything, are sure to recur.

PREPARED STATEMENT OF JACK KEMP

CO-DIRECTOR, EMPOWER AMERICA; FORMER SECRETARY OF HOUSING AND URBAN DEVELOPMENT, WASHINGTON, DC

MARCH 10, 1995

Mr. Chairman, Members of the Committee, thank you for inviting me to testify on the currency crisis in Mexico. This is an issue of vital importance, not only to the United States and Mexico, but, I believe, to the entire global economy.

I would like to commend you, Mr. Chairman, for your leadership and insight on this issue. Your decisive opposition to the Clinton Administration's original $40 billion loan guarantee plan prevented a costly misstep in policy which would have set us back even further than we are today.

I would also like to say that if the Administration had accepted the offer of Majority Leader Dole and Senator Bennett to develop a truly bipartisan effort to help Mexico revalue their currency and restore confidence in their economy, we would not be holding a hearing on this crisis today.

Let me make something clear, Mr. Chairman. The damage to Mexico was not caused by some mysterious outside force. It was caused by an explicit policy decision of the Mexican government on the advice of the Clinton Administration and international financial institutions such as the International Monetary Fund (IMF) and the World Bank.

Governments have a moral responsibility to protect the value of their currencies. Argentina's Minister of Finance, Domingo Cavallo, put it best when he said every peso is "a contract between the government and the peso holder." He could have said that same thing about the U.S. dollar or any other currency.

In my view, Mr. Chairman, there was never any need to devalue the peso in the first place. If the Bank of Mexico would have sold assets out of its own portfolio—to *reduce* surplus pesos instead of printing more of them—it could have kept the peso pegged to the dollar into the next century.

As it stands today, there is no end in sight to the decline of the peso. And there will be no end until the Mexican government establishes a credible peg of the peso which ultimately results in revaluing the Mexican currency to 3.5 to the dollar. Until we get that commitment, the Clinton Administration is, in effect, subsidizing the policy of devaluation which has created the crisis we face today.

The Mexican government is now engaged in a futile attempt to raise interest rates high enough to stop the flight away from the peso. But raising interest rates will not help because they tell us nothing about what's happening with the currency printing press. The Mexican government may be able to induce a few investors to hold short-term bonds, but they won't restore confidence in the peso or convince people that Mexico is a good place to invest for the long term.

As you know, Mr. Chairman, the result of Mexico's currency crisis has been a disaster on both sides of the border.

I spoke with Michigan Governor John Engler this week. He told me that Detroit's auto exports to Mexico have plunged since the peso devaluation. The people in Mexico are now too poor to be able to afford American cars. This hurts American workers and Mexican consumers.

Since the devaluation, the Mexican people have seen the value of their earnings and savings wiped out by nearly 50 percent. In effect, the Zedillo Administration is asking the people of Mexico to accept a permanent loss of savings and earnings to deal with a temporary trade imbalance—a trade imbalance caused by an inflow of capital into Mexico, a sign of vigor in the Mexican economy. Because of these worsening economic conditions, we are already seeing increased pressure on the U.S. border as more and more Mexican people seek better opportunity in the United States.

Beyond hurting the workers and consumers of both the United States and Mexico, the current crisis is undermining support for the North American Free Trade Agreement and all *future* free trade agreements as well. Free trade cannot be sustained under a policy of competitive devaluations and other beggar-thy-neighbor activities.

I have always believed America should help Mexico; our economic future is inextricably linked with our neighbors south of the border. But we should not acquiesce to the kind of austerity plan put forward by Treasury and the IMF—the type of plan which has brought economic misery to countless countries around the globe over the past decades.

I agree with you, Mr. Chairman, as well as Senators Dole, Bennett, Mack, and other Republican leaders that we can support the *general* idea of helping Mexico without supporting the *specific* idea of using U.S. taxpayer funds to bail out Mexican creditors.

In that regard, I opposed the Clinton Administration's original $40 billion in loan guarantees because there was no policy mechanism in this plan that would stabilize the peso, let alone strengthen it.

Furthermore, on January 24, 1995, I called for the resignation of IMF Chief Michel Camdessus for the complicity of the IMF in pushing Mexico toward devaluation. I believe the IMF should be held to full account for the disastrous policy they prescribed and the devastating economic and social consequences they have caused.

The good news, Mr. Chairman, is that it is not too late to repair almost all the damage that has been done to Mexico in these last 3 months.

In my view, the Treasury Department should advise Chairman Greenspan that it wishes him to deploy the Exchange Stabilization Fund solely to purchase pesos on the open market. It will do absolutely no good, as it has not in the last 3 weeks, to purchase interest-bearing peso assets, *cetes*, or *Tesobonos*. By itself, the purchase of these assets neither decreases the supply of pesos nor increases the demand for them.

Chairman Greenspan must also get the assurance of Bank of Mexico Director Miguel Mancera that the Mexican central bank will not purchase any assets with pesos until the peso/dollar rate is once again at 3.5 to the dollar—where it was on December 20, 1994.

Let me reiterate, Mr. Chairman: This can only be done if the Mexican government stops printing pesos and instead extinguishes them to reestablish a pegged, market-credible exchange rate of 3.5 pesos to the dollar.

Treasury Secretary Robert Rubin and Under Secretary Lawrence Summers will also testify on March 10. I believe there are several important questions they must be called upon to answer. At the risk of being too bold, Mr. Chairman, I would like to suggest a few ideas for Members of the Committee which I believe would shed much-needed light on the causes of the current problem and lay the foundation for a workable solution to the crisis.

1. Senior Treasury Department officials are now quoted as saying that Mexico had "no alternative" but to devalue the peso in December. This, to me, is incredible, especially in light of the financial crisis that immediately followed the initial devaluation—a crisis that still shows no signs of stabilizing. The collapse of the currency reflects an excess supply of pesos relative to demand. **Instead of devaluing, couldn't the Mexican government have maintained confidence in the currency by withdrawing excess pesos from the financial system?**
2. The Treasury–IMF "rescue package" is largely an attempt to refinance Mexico's short-term debt. Essentially, it is putting U.S. taxpayer funds at risk to buy interest-bearing Mexican assets. This program has nothing to do with restoring the peso's value, or even stopping its fall. Indeed, the peso's value has shrunk another 25 percent—half its total decline—in the 2½ weeks since the package was released. **On what basis can there be any expectation that this program will succeed without a concerted effort to restore the value of the peso?**
3. Instead of using the Exchange Stabilization Fund to buy Mexican bonds, the Federal Reserve could be instructed to start buying pesos. The Mexican monetary authorities would agree to extinguish the pesos acquired by the Fed. **Isn't this kind of action required to begin restoring the peso to its pre-devaluation rate of 3.5 per dollar?**
4. Some have suggested that such a program would be impractical because it would withdraw too much liquidity from the Mexican financial system and force interest rates to intolerable heights. But interest rates are spiraling ever-higher now because of the inflation expectations spawned by the devaluation. **Wouldn't a credible commitment to restore the peso's value reduce inflation expectations, restore investor confidence, and actually allow interest rates to fall?**
5. The austerity measures imposed on Mexico as conditions of the Treasury–IMF program appear to be based on the idea that somehow Mexico will be much better off if it suffers a major economic contraction. Reduced real wages, wage and price controls, sharply higher taxes, and skyrocketing interest rates—this is a recipe for

disaster, yet they are explicit conditions of our assistance. **Aside from direct economic effects, have U.S. officials considered the potential impact on Mexico's social and political stability? Are we prepared for the coming instability of the U.S. border when more and more Mexican people are forced to look for work in the United States?**

Mexico is currently on a path which has only produced economic stagnation, devastating inflation, and social unrest. But this course is not inevitable. Working together with the Zedillo Administration, America can help put Mexico back on the path of economic growth and low inflation which has done so much to promote democracy and freedom, not only in Mexico, but in all of Central and South America.

PREPARED STATEMENT OF ROBERT E. RUBIN

SECRETARY, U.S. DEPARTMENT OF THE TREASURY, WASHINGTON, DC

MARCH 10, 1995

Mr. Chairman and Members of the Committee, we welcome the opportunity to discuss with you the United States' response to the situation in Mexico.

I would like to summarize events leading up to President Clinton's decision to utilize the Exchange Stabilization Fund, in concert with a broader international effort to assist Mexico in a time of economic distress. But before going through some of the detail, there are several points I would like to make.

First, President Clinton acted to avert a crisis. There was only one criteria for acting, to protect our national interests—protect jobs, our standard of living, our national security, and counter potential surges in illegal immigration. These dangers to our interests reached beyond Mexico with the potential for a spill-over effect in the developing world where we have important markets and national security interests.

Second, there is no question that the President acted within his full legal authority in using the Exchange Stabilization Fund. And there is no impact on the ability of the ESF to protect the dollar.

Third, while Mexico has been through a period of political and economic difficulty in the past 14 months, it has committed itself to a stringent set of monetary and fiscal policies designed to restore confidence and enable Mexico to recover. Since we signed our agreements with Mexico, it has demonstrated its ability to tighten further, as by the fiscal measures and monetary steps announced last night, and by adjusting policies to raise short-term interest rates by 20 percentage points in the last couple of weeks. I would point out that since the first of the year, Mexico has brought down its outstanding Tesobono debt from $29.5 billion to $17.8 billion, almost a 40 percent reduction.

And fourth, we committed to fulfilling this program when we signed the agreements of February 21, 1995, a program announced by the President January 31, 1995, and endorsed by the bipartisan congressional leadership. The program is underway. Some $2 billion in short-term swaps outstanding from the earlier short-term arrangement will remain outstanding as short-term loans. Since the commitment made February 21, Mexico has done everything required of it. Yesterday, to fulfill our commitment, we approved the disbursement of $3 billion under the package of medium-term support. At the same time, the World Bank and IDB announced they intend to provide $2.25 billion to help stabilize and strengthen Mexico's banking system and $1 billion to support social sector programs. The Mexican Cabinet approved the additional fiscal and monetary measures announced in today's press. And President Zedillo will speak to his nation today to discuss his program.

Fifth, Treasury and Federal Reserve officials during 1994 communicated to Mexican authorities the belief that its policies were unsustainable. There were private sector parties who expressed the same view. On the other hand, many in the private sector shared the conviction with the Mexicans that they could enjoy a resumption of capital flows without significant policy adjustment. Even pessimistic observers who saw the Mexican situation as unsustainable did not expect a crisis that would bring Mexico to the brink of default. There have been many instances in which countries devalued their currency due to unsustainable fixed exchange rate policies, and in those situations markets almost always settled down after the initial moves. The probability of crisis is always very low and crisis is foreseen by few, if any.

As a sovereign nation, Mexico made its own decisions. The choices they made along the way in 1994 were unfortunate, but they have been made. Mexico must live with the consequences. And the United States—because of the critical stake we have in a successful resolution of this problem—acted as it did. I have said before,

and I will repeat here today, that the risk of failing to act was far greater than the risk of acting.

Having said that, the President first pursued a $40 billion legislative package to assist Mexico. Then came a day when the peso reached a then-record low and default looked like it could occur in a matter of days. At the same time, it became clear from the congressional leadership that Congress could not act within the required time frame. The President rightly concluded we only had two choices—to use the ESF or do nothing, with a high probability of default.

On January 31, 1995, President Clinton—with the support of the bipartisan congressional leadership and an acknowledgement of the legal authority to use the Fund—announced a decision to utilize the ESF to support Mexico's recovery. Three weeks later, I and other U.S. officials and our counterparts signed four carefully negotiated agreements implementing the United States' portion of the Mexican recovery program. Our assistance is designed to support Mexico in its tough and rigorous program designed to restore confidence in Mexico. It is built upon the program Mexico entered into with the International Monetary Fund.

I'd like now to offer some detail on the agreements we signed, including the tangible assurance of repayment, and the information we need to judge whether to meet a request for a tranche of assistance, or withhold assistance.

The four documents consist of a framework agreement covering the entire support package, an annex setting out that Mexico's obligations to the United States are backed through proceeds from exports of oil, oil products, and petrochemicals, an agreement covering medium-term swaps, and an agreement setting out the terms under which we are guaranteeing Mexico's securities. The support we are making available will be disbursed—providing Mexico is meeting its economic policy goals—over the next year or year and a half.

Mexico developed a financial plan that will utilize our support to restructure short-term debt into less volatile longer term obligations, and assist in maintaining banking system liquidity. If funds are used to help support the banking system, the shareholders of the banks may lose some or all of their investment, while depositors are protected. In two cases, already stockholders have lost all their shares. All the money in the $3 billion in assistance will be used to deal with public sector debt.

The support is in three forms: short-term swaps for dollars of up to 1 year, medium-term swaps for up to 5 years, and securities guarantees on government obligations up to 10 years.

We will charge Mexico interest rates and fees substantially higher than what the U.S. Government calculates is the level of risk we will bear. Our arrangement is structured to encourage Mexico to return to private sources for financing as rapidly as possible. The more they borrow from us, the more it's going to cost them. That's a substantial incentive to go back to the private market.

I want to dwell just briefly on the financial plan Mexico will pursue. Our agreements with Mexico start from the base of the IMF economic stabilization program, and we built upon that. Mexico must meet strict targets, such as cutting spending, running a budget surplus, and tightening credit to shrink the real money supply. In addition, they agreed to cut back development bank lending, accelerate both structural reforms in key sectors and privatization, as well as provide timely transparency. Let me say once again, the stringent measures announced last night are a major step forward, and we should recognize the political courage involved in taking these steps. By way of example, the fiscal measures Mexico announced last night will yield 1.5 percent of GDP. Measures of that scale in the United States would equate to $90 billion.

It is fair to ask how we will measure Mexico's performance. We took extraordinary steps to ensure we can see what Mexico is doing—look at the books early and often. They will begin publishing next week, on a weekly basis, the balance sheets of the central bank. The agreements ensure that Mexico will provide us all—I repeat all—the information necessary to determine how the Mexican economy is faring and whether Mexico is meeting its obligations. If we want more data, Mexico will provide it. And, as I noted in my letter to the Chairman Tuesday, the Administration is committed to sharing with Congress, in a timely manner, the information it needs to assess progress in Mexico and monitor the agreements.

Second, and this is a key point, we are disbursing our support in stages. There is strong conditionality. We must be satisfied that Mexico is making progress and meeting the terms of the agreements before we will provide any installment of assistance. They must tell us how they plan to use any particular tranche before we will release the funds.

There are three other important points to make here. First, responsibility for success clearly lies with Mexico. They have developed a stringent economic plan, and we have conditioned our support upon their performance. Second, we made it clear

we were willing to assist Mexico, but only if there were assurances we would be repaid, there was transparency, and there was monitoring. And, three, we have an assured means of repayment in the oil facility. Pemex—the state-owned oil company—has issued instructions to its foreign customers to make payments from the export of oil, oil products, and petrochemicals through the Federal Reserve Bank of New York, and these payments will automatically go to our account in the event of a default.

We negotiated carefully. There has been only one criteria in our action—the interest of the United States to protect its economy, its national security, and its interest with regard to illegal immigration, both as regards events in Mexico and any spillover into developing nations. The President, with the support of the bipartisan congressional leadership, acted in our national interest to avert a crisis. It was the right decision.

The agreements we have reached can assist Mexico in regaining economic stability, and prevent the crisis of a default.

There is full legal authority to use the ESF, and nothing in the agreements in any way impede our ability to protect the dollar.

I know there is genuine disagreement about the structure of the support package and whether it was the appropriate decision. It is a proper function of our political process to discuss such concerns.

However, I must emphasize that the key to our support package working is the restoration of market confidence. As I pointed out to the Chairman in my letter, while we welcome oversight by Congress, efforts by Members to impede the implementation of this program risk damaging market confidence in Mexico, and thereby reduce the prospects this program has. This program is sound, and it must be given an opportunity to work.

It was the right decision, and let me add, we must understand: The Mexican situation is a fact, and no matter how some people might like to wish its existence away, we share a 2,000-mile border. The lives of our people and our economies are inextricably linked.

We and Mexico's government fully recognize the circumstances are difficult. But I believe this is a sound program and that given a chance, it can succeed. This is not an overnight process. It will take patience.

Thank you.

PREPARED STATEMENT OF LAWRENCE H. SUMMERS

UNDER SECRETARY OF THE TREASURY FOR INTERNATIONAL AFFAIRS, WASHINGTON, DC

MARCH 10, 1995

Introduction

Mr. Chairman and Members of the Committee, I would like to use this opportunity to describe the events and circumstances that brought Mexico to its present state, to outline the choices Mexico faced and made along the way, and to explain the role the U.S. Government played in the events that unfolded last year.

Throughout 1993 and 1994 Treasury and the Federal Reserve were actively engaged in watching developments in Mexico. Secretary Bentsen had made one of his priorities the importance of moving beyond consultations with industrial nations, toward much greater involvement with emerging markets. He initiated a more intensive exchange with Latin American finance officials. He launched the APEC finance minister's dialog—of which Mexico is a member—and at its first meeting focused attention on the policy issues posed by capital market liberalization and the management of large capital inflows.

In this context, the Secretary and his Treasury staff placed great emphasis on Mexico. Federal Reserve and Treasury staff both closely monitored Mexico's situation throughout last year, and were in close contact with each other as well as with Mexican officials. As the year went on, Secretary Bentsen, officials at the Treasury, and Federal Reserve officials communicated repeated warnings to Mexican officials at varying levels that Mexican policy could be unsustainable. These warnings took on greater urgency as the year progressed. The policies that Mexico pursued, however, were Mexico's. And the choices Mexico made were Mexico's to make.

Let me say a few words briefly reviewing the economic events of the past 15 months.

Mexico began 1994 with very strong economic fundamentals, after 6 years of solid economic management and sweeping reform.

—Nearly 1,000 state-held industries had been sold off.
—Tariffs had been cut back sharply and quantitative restrictions on imports had been slashed. Many barriers to foreign investment had been eliminated.
—The government had transformed a budget deficit of 13 percent of GDP in 1987 into a nearly balanced budget—the equivalent of five Gramm-Rudmans, and the best fiscal position of any country in the OECD.
—The dollar value of annual Mexican exports had nearly doubled from 1980 through 1993.
—Real annual GDP growth averaged 3 percent between 1989 and 1994 compared to an average of 0.1 percent between 1982 and 1988.
—Inflation declined from over 150 percent in 1987 to 8 percent in 1993.
—Mexico in April of last year became the OECD's first new member in two decades, and one of the group's few developing member states.

This exceptional record of economic performance won the confidence of foreign investors. To be sure, Mexico had a large current account deficit, but going into 1994 Mexico was attracting enough investment to fund this deficit comfortably. Most investors viewed the deficit as sustainable, as it was being financed by private capital inflows which were apparently being used to fund investment, not consumption or government spending. In fact, the level of foreign portfolio and direct investment reached $33.5 billion in 1993, and was sufficiently high in early 1994 to force the Mexican authorities to intervene in the foreign exchange market to prevent the peso from appreciating beyond the upper limit of their exchange rate band.

Mexico had experienced some disruption of capital inflows in November 1993, during the U.S. debate over the adoption of NAFTA. The United States, in cooperation with a group of other countries acting through the Bank for International Settlements, put in place a contingency short-term financing facility for Mexico. In the event, the facility was not needed, and flows resumed quickly once NAFTA was adopted. That experience became the prism through which Mexican authorities would come to view disruptions in flows throughout 1994.

Recognizing the importance of monitoring exchange rate fluctuations in the context of an expanding trade relationship, in late 1993 Treasury and Federal Reserve officials began considering the establishment of a standing consultation mechanism with the Canadian and Mexican monetary authorities on macroeconomic policy issues. In this context, U.S. officials, in conjunction with Canadian authorities, also initiated consideration of enlarging the standing short-term swap facility we had had in place with Mexico over the last 50 years.

This contingency planning provided the basis for the Treasury's and the Federal Reserve's quick response to the assassination of Mexican Presidential candidate Colosio on March 23, which prompted a sharp decline in Mexican financial markets and a fall in the peso. At the request of the Mexican authorities, we put in place a temporary $6 billion swap facility to counter exchange market pressures associated with the resulting political uncertainty.

Later that spring, we established the North American Financial Group and, in conjunction with Canadian authorities, made the temporary swap facility a standing arrangement. It is worth recalling that, prior to concluding the temporary swap facility, we sought an assessment by the International Monetary Fund of Mexican economic policies. On that occasion the IMF provided a strong and unqualified endorsement of Mexico's economic management.

As part of the new consultation mechanism, Federal Reserve officials were now in weekly touch with their Mexican and Canadian counterparts. Secretary Bentsen and Treasury staff maintained close contacts with their counterparts at the Mexican Ministry of Finance.

The Mexicans understood that the swap mechanism was to be used only to counter short-term financial instability. It would not be used to bolster exchange rate or macroeconomic policies which were fundamentally unsustainable.

Mexico's experience during the NAFTA debate shaped Mexican authorities' evaluation of the reserve losses and exchange rate pressures which followed in the wake of the Colosio assassination. While they did increase interest rates substantially in March and April, Mexican authorities expected capital inflows to strengthen once market instability faded, as had occurred after the NAFTA episode. On the basis of that assumption, Mexican officials later in 1994 chose to sterilize the effects of foreign reserve losses on monetary conditions.

The government also increased its reliance on borrowing through Tesobonos, or dollar-indexed short-term securities. These securities' link to the dollar apparently served to reassure investors that Mexico did not intend to devalue, and that currency risk was minimal. In retrospect, however, this increased reliance on short-term dollar-linked obligations helped bring on Mexico's present liquidity difficulties.

At this point, a lively debate about Mexican policies was underway in financial and academic circles. A solid number of market and economic observers continued to believe that Mexico's current account and macroeconomic policies were sustainable, and that capital flows would resume once the political situation stabilized. These views tended to prevail over the concerns expressed by some private analysts and academics, as well as those held by U.S. officials, about the increased risks Mexico was facing.

Nonetheless, by early summer U.S. officials' concern about the size of Mexico's current account deficit, and the sustainability of Mexico's underlying macroeconomic policies, had become more serious. The rise in Mexican interest rates as well as Mexico's financial innovations had not succeeded in lifting the country's foreign currency reserves back to levels at which they had stood before the Colosio assassination. As has been subsequently revealed, Mexican authorities over the summer asked the Federal Reserve and the Department of the Treasury to help arrange a supplemental $6 billion contingent credit line from other countries to be used in the event of political uncertainty. Treasury and Federal Reserve officials perceived increased risks in Mexico's policy course, and communicated these concerns to the Mexicans. These risks involved Mexico's attempt to maintain a fixed exchange rate in the face of a current account deficit that foreign investors were increasingly reluctant to finance without changes in Mexican economic policies that would have made Mexican financial assets more attractive.

At this stage, Mexico still had a range of policy options it could have pursued to remedy the situation. Sharply higher interest rates could have been used to make Mexico more attractive for capital. Accelerated privatization would have increased the demand for pesos, bolstering the exchange rate while raising competitiveness and efficiency. Some modification in Mexico's exchange rate mechanism could have been pursued, without major disruptive effects.

Unfortunately, despite U.S. warnings and a continued absence of resurgent capital flows, Mexico did not make substantial policy adjustments. The Mexicans believed it was unreasonable to judge the sustainable level of capital flows based on the level of flows during the run-up to the August election, a period of uncertainty during which flows were thought to be weaker than normal. Mexican hopes were fueled by optimistic voices in economic and market circles which continued to predict that capital flows would resume after the vote. These hopes delayed consideration of the policy changes necessary to restore investor confidence and finance the large current account deficit.

A modest resumption in capital inflows and a slight appreciation of the peso following the August 21 election contributed to Mexican hopes. However, in line with U.S. officials' fears and warnings, this resumption proved to be short-lived. The September announcement of a new pact between government, industry, and labor officials, which reaffirmed existing exchange rate policies, included none of the needed macroeconomic policy adjustments.

Exchange rate pressures resumed in October. By mid-November, as tensions mounted in Chiapas and the inauguration approached, Mexico began to confront severe exchange rate pressures. Treasury and Federal Reserve officials continued to communicate to the Mexicans their grave concern that Mexico's policies were fundamentally unsustainable. Given the U.S. view of Mexico's economic situation, there were no drawings permitted on the standing swap lines. As I have said, it had been the Federal Reserve's and the Treasury's position all along that the United States would only allow use of the line to counteract short-term financial pressures such as those associated with political instability, not to prop up the currency in the face of policies that were fundamentally unsustainable.

By December 20, Mexico was losing reserves at an extremely rapid rate. The Mexican authorities decided on the night of December 19 that their exchange rate could not be defended, and notified us at that time. They announced the next morning an adjustment of their exchange rate band. Unfortunately, as Mexican authorities have since acknowledged, their devaluation was not well handled, in terms of communication with the investment community, or with the international financial institutions. Moreover, the Mexicans did not accompany their announcement with any other new policy actions. Within 2 days, Mexico had no choice but to float the peso. By waiting as long as they did to act, Mexico deprived itself of its ability to use other policy options that might have allowed them to avoid devaluation. It is highly unlikely that by late December, a tighter monetary policy would have been sufficient to maintain the band.

The combination of the mishandled devaluation, the further depletion of nearly half of remaining reserves in the defense of the new band, and continued political shocks created a loss of confidence that soon cascaded into a serious financial disturbance. By early January, Mexico was on the brink of default.

Let me be clear. This was not an outcome that had been foreseen. Even observers who foresaw the possibility of an exchange rate crisis expected the kind that has occurred in recent years in Europe, not a set of events that would call a nation's ability to service its obligations into question.

Conclusion

Ultimately, it was Mexico's own choices—regarding macroeconomic policy during the year, and how to devalue, then float the peso in late December—which prompted Mexico's present difficulties. Treasury and Federal Reserve officials expressed their mounting concerns to the Mexicans throughout the year. But Mexico is a sovereign nation. The United States could not force policy choices upon them.

The lesson from Mexico's experience is that policies matter. There is no substitute for maintaining strong macroeconomic policies. No institution and no foreign government can save a country from that imperative. Nonetheless, it is in our interest, and in the interest of the international community, to ensure that we develop mechanisms to deal as effectively as possible with these situations in the future.

Thank you.

PREPARED STATEMENT OF PETER TARNOFF

UNDER SECRETARY OF STATE FOR POLITICAL AFFAIRS, U.S. DEPARTMENT OF STATE, WASHINGTON, DC

MARCH 10, 1995

Thank you. Mr. Chairman, Members of the Committee, I welcome the opportunity to be here with you today to discuss our relations with Mexico.

The United States has fundamental national interests, both economic and political, in a stable and prosperous Mexico. What happens in Mexico affects our economic security. It affects our quality of life, particularly in the Southern States. We also have a national interest in promoting regional progress in opening markets and political systems, as the consensus of the Summit of the Americas so powerfully demonstrates. And we have an interest in maintaining America's leadership in the region.

Mexico's political stability is key to our own domestic security, and to the security and prosperity of Latin America. President Zedillo has committed to complete Mexico's transition to full democracy, and the headlines bear out the positive steps he is taking:

—Free and fair elections in Jalisco last month resulted in the victory of an opposition candidate as Governor of the state for the first time in history;
—Consultations with opposition party leaders resulted in an important interparty agreement on political reforms.
—Reinvigorated investigations into recent political assassinations prompted the arrest of two significant political figures, validating President Zedillo's commitment to justice and judicial reform.

In Chiapas, President Zedillo has sought to regain authority over the area while continuing to offer to negotiate with the EZLN. More importantly, he has committed his Administration to addressing the social and economic inequities underlying the EZLN's complaints. This week, the Mexican Congress is meeting in special session to address ways to improve the situation in Chiapas.

These measures are key indicators of Mexico's continued transition toward full democracy. Progress already made is significant—Zedillo's own electoral victory came after the cleanest elections in Mexican history. But the Mexicans recognize the need for further reform, and are taking the necessary—and sometimes difficult—measures to achieve it.

Mr. Chairman, a politically stable, economically sound Mexico means that we can go forward with the Mexican government on a range of bilateral initiatives that directly affect the quality of life and prosperity of Americans, especially those who reside along or near our 2,000-mile border with Mexico. Our level of cooperation is already good—it can always improve, and I believe it will. Let me just highlight some areas of recent progress:

—We share a commitment to end cross-border crime and alien smuggling. Last month, the government of Mexico agreed to deploy additional elite police forces along the border, and to better secure bridges and border crossing areas against those who seek to enter the United States illegally.

—We stand together against illicit drug trafficking, which President Zedillo called Mexico's most serious national security problem. Over the past 6 years, our cross-border cooperation has led to seizures by the Mexican government of over 120 metric tons of cocaine, tens of thousands of arrests, and the eradication of thousands of hectares of opium poppy and marijuana. In a meeting just last month, we agreed with the Mexicans on additional measures to combat money laundering, facilitate extradition, and control the flow of precursor and essential chemicals. We also agreed on the need to dismantle trafficking organizations and bring their leaders to justice.

—We seek to preserve our shared environment, a goal we have jointly pursued since the establishment in 1889 of what is today the International Boundary and Water Commission. As a result of NAFTA, the newly-created Border Environment Cooperation Commission and the North American Development Bank will help develop and finance badly-needed environmental infrastructure along the border.

Mr. Chairman, in closing, let me state that we believe that Mexico is on the path to financial recovery, to a more secure expression and implementation of democratic ideals, and to economic well-being for its people. The path is not an easy one and will require severe sacrifices on the part of the Mexican people. President Zedillo is determined to succeed. President Clinton and his Administration are determined to assist Mexico because we are neighbors and friends and because it is in our Nation's overriding security and economic interests to do so.

The Wall Street Journal

Wednesday, February 8, 1995

MEXICO: Suffering the Conventional WISDOM
By Robert L. Bartley

Confusion number one is that the best exchange rate is one that produces the "right" trade balance. With the collapse of Marxism now behind us, this has become the most pernicious idea loose on the earth today.

-- "Dollar Turmoil," Review & Outlook, The Wall Street Journal, May 23, 1989.

So some 93 million Mexicans are learning to their sorrow. But perhaps there is something to be redeemed from their misery. Just possibly the debacle will spell the end of devaluation as a policy instrument, not only in Mexico but around the world.

The initial conventional wisdom is quite the opposite, of course. With the peso devaluation proving an utter calamity, financial sophisticates have decided the mistake was not doing it sooner. To the untutored, this logic may not be intuitively obvious. Indeed, taxpayers who've ponied up some $50 billion in guarantees may be relieved to discover there is another view: that the Dec. 20-22 devaluation was a dreadful mistake, though one in which the Mexicans merely followed prevailing conventional wisdom.

That wisdom holds, for example, that Mexico was "forced" to devalue, which is myth number one. A collapsing currency is usually the sign of an economy with an inflationary spiral and an uncontrolled fiscal deficit. But the Mexican budget was nearly in balance, and the ratio of its debt to GDP was below the OECD average. Inflation had subsided to single digits. Exports were surging, up 35% to the U.S., scarcely the sign of an "overvalued" currency. Growth, while not as vigorous as some developing nations, was picking up in the wake of the North American Free Trade Agreement. The real sector of the economy was not sick but healthy.

In the financial sector, the incoming Zedillo administration did inherit a problem: Foreign exchange reserves were declining. As recorded in the graphs Bank of Mexico Governor Miguel Mancera published on this page Jan. 31, adapted alongside today (see accompanying illustration -- WSJ Feb. 8, 1995), they'd fallen from a peak of nearly $30 billion before the March assassination of Presidential nominee Donaldo Colosio to about $12 billion at the Zedillo inauguration Dec. 1.

In dealing with this problem, however, the incoming administration had a

choice. The road not taken was simply to tighten monetary policy. In the conventional view, this means raising interest rates to attract dollar inflows and thus stabilize reserves. In the more modern and more helpful monetary approach to the balance of payments, the same actions would be viewed as reducing the supply of pesos. A lower supply of pesos relative to the supply of dollars would increase the value of the peso, and a higher exchange rate would reduce the incentive to cash pesos for dollars. Reducing the supply of pesos would also be likely to boost short-term interest rates, though this is a side-effect, and long-term rates might actually benefit.

Instead the Mexicans chose to devalue, widening the bands on the exchange rate on Dec. 20 and going to a freely floating rate on Dec. 22. The latter decision really was forced because the earlier one collapsed investor confidence in the peso. Widening the bands clearly presaged devaluation and led to a massive flight from the peso, and the loss of half of the remaining reserves in one day. Judging by their public economic plans, the Mexican authorities had in mind an exchange rate of 4.5 pesos to the dollar, a 22% devaluation from the earlier 3.5 floor. But with confidence imploding, the peso dropped immediately to 5.5, then as low as 6.33, a 45% devaluation. With more than $50 billion in guarantees from the U.S. Exchange Stabilization Fund, international financial institutions and commercial banks now announced, the peso recovered to 5.335 yesterday, devalued 35%.

Meanwhile, interest rates surged. In the wake of devaluation, the rate on 28-day cetes, peso-denominated Treasury bills, reached 39%, up from 13.75% in the Dec. 14 auction. Even with the support package, the 28-day cetes rate was 32.57% at the most recent auction Feb. 1. Foreign exchange reserves were almost exhausted before the bailout package, and the Mexican economy is visibly collapsing into recession. The argument that Mexico was "forced" to devalue rests on the notion that otherwise it would have vanishing foreign exchange reserves, a recession and soaring interest rates. With devaluation more than doubling interest rates, it's absurd to suggest that the same rates would not have been enough to defend a 3.5 peso exchange rate when the former level of confidence still prevailed.

What's more, in all likelihood the damage has only begun. Mexican living standards already are plunging. The devaluation will surely result in a major surge of inflation, which will offset any imagined trade advantages to a lower exchange rate. The combination of inflation and recession will throw the government budget into chaos. The economic turmoil, especially the devastation of the nascent middle class, will in turn produce political turmoil. Much of the hard-won progress of the last 12 years will be reversed.

The Mexican outcome provides a particularly clear empirical test of a set of conventional wisdoms about economic policy, trade and exchange rates. For this was not some backwater decision. The key decision-makers in Los Pinos (the White House) and Hacendia (the Treasury) boasted Ph.D.s in economics from Yale and Stanford. Devaluation has long been urged by important business sectors in Mexico, and advocated/predicted by various commentators on Mexico, in particular journalist Christopher Whalen and MIT economist Rudiger Dornbush.

When the action was taken, U.S. Treasury Secretary Lloyd Bentsen immediately said it "will support the healthy development of the Mexican economy."

The arguments of this illustrious group are familiar: Exchange rate pressures are caused and cured by trade deficits. Thus the Mexican authorities thought their fundamental problem was not purely monetary, but rather a high current account deficit. And further that the deficit could be cured by devaluation; a lower exchange rate would make Mexican goods cheaper north of the Rio Grande and U.S. goods more expensive south of the border. So Mexicans would sell more and buy less, and the trade account would come into balance, or at least to a "sustainable" level. Many economists and such institutions as the International Monetary Fund have long given the same advice to every troubled economy in the world. It was the conventional wisdom preached even to the U.S. in the 1980s, the occasion of the "Dollar Turmoil" editorial quoted above.

Yet in fact trade deficits are perfectly normal, if not indeed a sign of health. The international balances are an accounting identity, and trade deficits and investment inflows are two sides of the same coin. So any developing nation that succeeds in attracting capital must by definition run a trade deficit. Or to put it another way, a rapidly growing economy will attract more than its share of the world's investment and require more than its share of the world's goods.

The key, then, is not to balance the current account with the rest of the world, but to balance trade deficits with voluntary investment inflows. Mexico ran current account deficits of $25 billion in 1992 and $23 billion in 1993, and during this time not only maintained the peso at around 3.1, but accumulated large foreign reserves. In 1994, the current account deficit was only slightly higher -- $27 billion after 11 months. The problem came with the inflows, as political turmoil shook investor confidence.

The biggest shock was the Colosio assassination. The Salinas administration responded by devaluing the peso to 3.4 from 3.1, within the previously announced bands. It also used some of its foreign exchange hoard to buy pesos and engineered a sharp boost in interest rates, taking 28-day cetes to around 18% from 9.6%. This mix succeeded in stabilizing foreign reserves from April to November, with a blip over the threatened but ultimately aborted resignation of Jorge Carpizo McGregor, widely seen as the Mexican government's badge of integrity. In November, reserves resumed their fall with the angry resignation of Deputy Attorney General Mario Ruiz Massieu, who had been investigating the assassination of his brother, Jose Francisco Ruiz Massieu, secretary general of the ruling Institutional Revolutionary Party (PRI) who had tried to fight party corruption. The resigning official repeated his suspicions that drug dealers were working with elements of the PRI, and charged that high party officials had obstructed his probe.

Clearly these political events were shocks to monetary policy and the exchange rate, as Governor Mancera argued in his article here. He added, however, that in line with standard central bank practice around the world, the resulting foreign exchange transactions had been "sterilized," or offset with

domestic transactions. The idea is to insulate domestic monetary policy from the impact of international markets (though in fact both turn on the same money supply). So the central bank would sell its dollar reserves, thus withdrawing pesos from circulation, but then would buy domestic notes and bonds, putting the same pesos back in circulation.

So internal measures of "the money supply," the monetary base for example, displayed their usual growth path with their usual seasonal variations. But the point was that the political shocks changed the demand for money; the supply was not allowed to adjust. In effect, the central bank created the pesos used to buy away its dollar reserves. With a large stock of reserves and a store of credibility earned with the Salinas reforms, the sterilized interventions did buy time for a monetary correction, but instead the new administration decided to devalue. The $50 billion support package has restored some stability, but without policy changes Mexico could sterilize its way through $50 billion as it just sterilized its way through $30 billion.

It would be quite another matter if some of the $50 billion were used for unsterilized intervention, buying pesos and extinguishing them. And while sterilization is indeed standard policy under the international conventional wisdom, it is not the only possible one. Indeed, the currency board policies adopted in Hong Kong, Argentina and Estonia operate on a contrary principle. Local currency is issued only when new foreign exchange reserves are earned, and is extinguished when reserves fall. Interestingly, Argentina reacted to the Mexican crisis by eliminating its remaining bands, not widening them. Finance Minister Domingo Cavallo clearly has not adopted the conventional wisdom; indeed, he consummated his currency board by inviting IMF advisers out of his nation.

The currency board arrangement is reminiscent of the classical gold standard before World War I, when the domestic monetary base automatically rose or fell with the gain or loss of gold reserves. The currency boards use foreign currency instead of gold, of course. This means that while all nations could use the gold standard, with currency boards one central bank, presumably the Federal Reserve, would have to use some other outside signal in setting the pace of money creation.

The new Republican Congress is gearing up for hearings about what went wrong in Mexico, which promise to become a re-examination of the prevailing conventional wisdom. Clearly the Republicans recognize the devaluation as a mistake, as Senate Majority Leader Bob Dole has plainly stated. What advice, Republican committees want to know, did the Mexicans get from the IMF and U.S. Treasury? And what advice will they give the future Mexicos?

When the GOP won in November, who would have guessed that one of the first effects would be a far-reaching examination of international monetary policy? Even for us who thought its arcane mysteries were as dangerous as they've now proved in Mexico, it seemed too much to hope.

Mr. Bartley is editor of the Journal.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

March 28, 1995

The Honorable Alfonse D'Amato
Chairman
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

Thank you for the opportunity to submit for the record Treasury's responses to questions on Mexico raised by Jack Kemp at the Banking Committee hearing on March 10, 1995. Treasury's responses to Mr. Kemp's questions are enclosed.

I would also like to respond to a question you raised during the hearing concerning the amount of Eurodollar obligations of Mexico. Our most recent data show that as of March 21, there were US$8.055 billion of Eurobonds outstanding, issued by the Government of Mexico, Mexican commercial banks, and Mexican corporations.

I appreciate your keen interest in the Mexican financial crisis, and want to reiterate my personal assurances that Treasury will work closely with your Committee so that it can perform its oversight responsibilities.

I look forward to working with you on this and other matters in the future.

Sincerely,

Robert E. Rubin

Enclosure

Jack Kemp's Testimony: Answers to Questions

1. Couldn't the Mexican Government have maintained confidence in the currency by withdrawing excess pesos from the financial system?

Between March and November 1994, the Bank of Mexico did not respond as it should have to counter the large-scale capital outflows and loss of reserves. A tightening of money and credit policy might have stemmed the capital flight. This would not, by itself, have had a strong effect on Mexico's large current account deficit. Whether in retrospect devaluation could have been avoided by timely and forceful policy response is not a question that can be answered definitively.

By mid-December, a crisis of confidence had developed. The international reserve level of the Bank of Mexico had fallen to a low level and short-term obligations were falling due. The Bank had very limited recourse to reserve sales to soak up pesos as a means for tightening financial conditions. As Chairman Greenspan testified, by December the Mexican authorities probably had no realistic alternative to allowing the peso to float.

2. On what basis can there be any expectation that this program will succeed without a concerted effort to restore the value of the peso?

To maintain a strong and stable peso is the central objective of Mexico's economic program. Key to that program's success is to control the growth of credit and thereby limit the quantity of pesos. That approach is needed so that the exchange rate will appreciate, so that inflation will come under control, and so that interest rates, in time, will come down.

The Mexican authorities have decided that in the present uncertain market environment, it is prudent and more credible to seek to strengthen the exchange rate through the control of credit. They believe that attempting to peg the peso exchange rate to the dollar, by itself, cannot succeed.

3. Isn't this kind of action (the use of the ESF by the U.S. Federal Reserve to purchase pesos) required to begin restoring the peso to its pre-devaluation rate of 3.5 per dollar?

The ESF is being used to purchase pesos and thereby to strengthen the peso exchange rate. Mexico's monetary predicament, however, is more difficult than is often portrayed.

Mexico's liquidity crisis threatens a huge expansion of the money supply. In the first half of 1995, US$18 billion in Tesobonos and Cetes held by foreigners matures. Mexico must either redeem

those obligations or default. Redemption in pesos would triple the size of base money (the monetary liabilities of the Bank of Mexico) and lead to an inflation and depreciation spiral.

There are two options for avoiding that outcome:

- o Float new bonds to roll over maturing obligations. Mexico has been hardpressed to sell new peso instruments, because market confidence is so badly shaken. Default expectations have been so strong that it has proven difficult to sell peso bonds even at very high interest rates.

- o Sell dollars to soak up the pesos. That option is complicated by Mexico's low international reserves and the fact that in the first quarter Mexico faces US$8 billion in maturing external debt (beyond the Tesobonos and Cetes).

Mexico's strategy, and ours in supporting Mexico, is to raise the prospect for exploiting both options, by

- o Strengthening fiscal and monetary policy to regain credibility and make it possible to sell peso bonds.

- o Selling dollars borrowed from the U.S. ESF and IMF to avoid peso creation in connection with Tesobono redemption.

In sum, the U.S. ESF support package is being used to avoid the creation of pesos. A tightening of Mexican policy, supported by the U.S. ESF, has resulted in base money (the Bank of Mexico's peso monetary liabilities) falling by 8 billion pesos (or about 14 percent) since the beginning of the year. Narrow money (M1) has also fallen sharply. While there is always a seasonal decline in base money and M1 in the first quarter, there have been larger declines than usual.

As for the proper scale of monetary tightening, it has been the judgement of the Mexican authorities, with which the U.S. Treasury, the Fed Board of Governors, the IMF, and many private sector analysts concur, that it is not feasible to soak up enough liquidity to restore the exchange rate to 3.5 pesos per dollar. The likely consequences of an attempt to do so would be to damage the Mexican financial system so severely that the effort would be counterproductive.

4. Wouldn't a credible commitment to restore the peso's value reduce inflation expectations, restore investor confidence, and actually allow interest rates to fall?

Yes, the objective of Mexico's economic program is to lay as sound a foundation as possible for the strengthening of the peso. The sustained implementation of Mexico's program would bring about the benefits mentioned in the question.

Moreover, the Mexican authorities aim to stabilize the exchange rate at as strong a parity as possible, and as soon as possible. President Zedillo commented in recent days on his intention to introduce a more fixed exchange rate regime as soon as stability is possible.

There remain different views with respect to the proper level of the external value of the peso. As mentioned above, a policy aimed at restoring a parity of 3.5 pesos per dollar has two drawbacks: it would require a large amount of dollar sales (in light of the need to avoid money creation arising from short term debt redemption) and it would require such a strong contraction of the money supply that it would severely damage the Mexican financial system.

5. **Have U.S. officials considered the potential impact on Mexico's social and political stability? Are we prepared for the coming instability of the U.S. border when more and more Mexican people are forced to look for work in the U.S.?**

In extensive discussions within the Administration and in consultations with members of Congress early this year, the administration found considerations about social and political stability in Mexico among the most compelling reasons for a swift and forceful U.S. response to this crisis. The social and political stability of Mexico is of paramount importance, both with respect to that country's future and to U.S.-Mexican relations. A well designed and well implemented economic program, aided by the support the United States is providing, offers the best chance of ending the present currency crisis and thereby minimizing the risks of instability.

BOB DOLE
KANSAS

United States Senate

OFFICE OF THE MAJORITY LEADER
WASHINGTON, DC 20510-7010

March 10, 1995

The Honorable Robert E. Rubin
U.S. Department of Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Dear Mr. Secretary:

As you may know, I recently expressed my views on the Administration's use of the Exchange Stabilization Fund (ESF) to aid Mexico. In order to avoid any misperception about my position, I have attached a copy of my statement.

On January 31, in an effort to avoid complete financial collapse in Mexico, I participated with other Congressional leaders in a statement supporting the President's use of the ESF. However, this expression was not intended and should not be construed to convey my blanket support for the underlying policies of the Administration or for the economic and legal agreements implementing those policies. To the contrary, I reserved these judgements. I have since cautioned the Administration to be careful in its use of the ESF and I have expressed deep reservations about the shortcomings of the agreements.

My good faith effort in January to cooperate with the Administration in no way should be interpreted as any protection from legitimate and responsible Congressional oversight. Congress and its Committees have every right, and the Constitutional duty, to examine thoroughly the Admisistration's conduct and policies towards Mexico, and certainly, to oversee the expenditure of billions of dollars in taxpayers funds.

I support fully the Banking Committee's ongoing examination of the important issues raised by the Mexico situation. To further public understanding of the program and sustain the original spirit of cooperation and bipartisanship, I urge the Administration to cooperate fully and completely in this effort.

Sincerely,

BOB DOLE

cc: Chairman D'Amato
Banking Committee Members

FINANCIAL AID TO MEXICO

Mr. DOLE. Mr. President, when President Clinton announced a financial package to aid Mexico in its current economic crisis, Speaker GINGRICH and I announced our support. Mexico was, and is, of vital importance to the United States. In my view, we could not stand by and watch Mexico financially melt down if there were any realistic chance to help.

Earlier this week, an agreement was signed between the United States and Mexico, and its full details were released to the public. I have analyzed it, with the help of staff, outside advisers, and other Senators. I find it somewhat surprising and, at its core, disappointing. My message should not be misinterpreted—I do want United States efforts to assist Mexico to work. I hope we can help Mexico achieve the financial stability that they so desperately need. However, I must reluctantly point out the shortcomings of the agreement reached this week.

In my view, the basic mistake Mexico made last year was allowing events to get to the point where the only apparent choice was to devalue the peso. Perhaps the Government believed that a little devaluation would be a good thing.

Common sense should have recognized that Mexico's decision to break its promise to the Mexican people to keep the peso stable against the dollar would precipitate a breech of trust—a stampede to get out of pesos and into dollars.

The Treasury Department needs to be very careful in the use of funds from the exchange stabilization fund. For example, I am not convinced that thrusting the United States into the middle of a Mexican banking crisis is prudent or necessary.

The primary focus of the stabilization plan is not aimed at reversing the fundamental mistake of devaluation—not now and not over time. The measures described in the agreement to firm up the price of the peso seem almost an afterthought. They do not address the problem of extinguishing the excess pesos that have been coming off the Mexican printing presses, even as recently as last week. The heart of the problem is restoring confidence in Mexican pledges by moving toward restoring the value of Mexico's currency, and I hope it is not too late. I hope that administration officials will still focus on the main target: extinguishing pesos and restoring confidence in the Mexican currency. This should be the first priority, not raising interest rates.

It appears my concerns are shared by the markets. When it was first announced that the United States would help Mexico, the Mexican stock market went up and the peso strengthened. Yet when the exact terms of the deal were made public, the peso weakened and the stock market resumed its slide.

In the coming days and weeks, Congress will examine many issues in the Mexico situation—what advice the administration gave, when officials knew about the devaluation, allegations of conflict of interest, and other issues. I am also working with the administration to send a group of Senators to Mexico in the near future to get a first-hand assessment of the situation. A central part of that assessment will be looking at whether the administration's proposed medicine will cure the disease.

Statement With Congressional Leaders on the Economic Situation in Mexico

January 12, 1995

We agreed that the United States has an important economic and strategic interest in a stable and prosperous Mexico.

Ultimately, the solution to Mexico's economic problems must come from the people of Mexico, but we are pursuing ways to increase financial confidence and to encourage further reform in Mexico.

We agreed to do what is necessary to restore financial confidence in Mexico without affecting the current budget at home.

NOTE: The statement was announced jointly with Newt Gingrich, Speaker of the House of Representatives, Robert Dole, Senate majority leader, Thomas Daschle, Senate minority leader, Richard Armey, House majority leader, and Richard Gephardt, House minority leader.

The Washington Post, January 14, 1995

HEADLINE: U.S. **Plan to Aid Mexico** Calms Financial Markets; Loan Guarantees Get Cautious Hill Backing

SERIES: Occasional

BYLINE: Clay Chandler , Martha M. Hamilton, Washington Post Staff Writers

BODY:

The Clinton administration's plan for bailing out Mexico's economy calmed investors yesterday and buoyed the peso. It also drew cautious, but generally favorable reviews from members of the new Congress.

The Mexico rescue plan -- a package of $ 40 billion in loan guarantees outlined Thursday night after a White House meeting between President Clinton and congressional leaders -- boosted stock prices and currencies throughout the hemisphere yesterday. Analysts said the size of the package -- at the high end of the range described Thursday night -- appeared to be big enough to sustain investor confidence.

The peso rallied sharply to close at 5.25 to the dollar, a strong gain from Thursday's 5.5 rate. When the crisis began Dec. 20, the peso was trading at about 3.4 to the dollar. Stock prices surged 4.6 percent on the Mexico City market, with the main index up 97.7 points to close at 2,216.55.

"There is definitely a floor under the market that wasn't there before the announcement," said Thomas Trebat, Chemical Banking Corp.'s managing director responsible for emerging markets research."

John Daly, senior vice president-global fixed income of John Hancock Mutual Funds, declared: "The worst of it is behind us."

Yesterday morning, as markets took the measure of Thursday night's announcement, Treasury Secretary Robert E. Rubin and Federal Reserve Chairman Alan Greenspan canvassed Capitol Hill, briefing legislators on the details of the plan and lobbying for support.

At a question-and-answer session attended by more than 100 legislators yesterday morning, many members of Congress questioned Rubin and Treasury Undersecretary Lawrence H. Summers about whether the proposed rescue package would put U.S. tax dollars at risk. And some demanded assurances that the United States would extract broad promises of economic reform from the Mexican government before the Treasury extended any financial support.

"I'm going to need a lot more information before I sign on the dotted line," said Sen. Tom Harkin (D-Iowa).

But at the close of the two-hour meeting, House Speaker Newt Gingrich (R-Ga.) told the gathering that the Republican leadership in the House stood firmly behind the administration's rescue plan. "We have zero choice on this," he said, according to those who attended the meeting. The Republican leadership, he added, is committed to doing "everything we can to make it work."

"There's generally a consensus that, as the leadership agreed last night, we need to do what's necessary to make this work," Senate Majority Leader Robert J. Dole (R-Kan.) said after the morning meeting. "We don't have the luxury of waiting very long," he added.

To succeed, the plan needs speedy endorsement on the Hill. Delays and protracted bickering over budget issues or conditions of the loan guarantees could trigger another slide for the peso, Treasury officials and investors said yesterday. But timing for congressional action on the plan remains unclear.

"I think the timetable will start to gel early next week," said Sen. Robert F. Bennett (R-Utah), a member of a task force of Senate Republicans who met in Dole's office yesterday afternoon to discuss handling of the measure.

Without the approval of Congress, the administration will not be able to translate the financial support proposal -- which closely resembles a similar formula devised to extend loan guarantees to Israel in 1992 -- into action. Under budget law, the government must set aside money to cover any potential losses from loan guarantees, a move requiring congressional consent.

In some ways, congressional reaction to the administration's proposal yesterday mirrored the divisions that arose during the 1993 battle over the North American Free Trade Agreement, with pro-labor Democrats and some conservative Republicans raising doubts about the plan.

"What I want to know is: 'How much is it going to cost us really?' " said Sen. Ernest Hollings (D-S.C.), one of NAFTA's most strident critics, of the Mexican assistance plan.

Lawmakers from both parties said they would feel a lot more comfortable about voting to back up the peso if other wealthy nations could be persuaded to share the financial burden. "If the Mexican default is a major risk to the global economy, it sure seems to me that the Japanese and the Europeans should be involved," said Sen. Joseph I. Lieberman (D-Conn). Rubin and Summers argued yesterday that there simply wasn't enough time to line up international cooperation.

"I think something has to be done" to shore up the Mexican economy, said Sen. Bill Bradley (D-N.J.). Without prompt U.S. action, the peso's collapse threatens to "ripple through the whole world economy," he said. But Bradley, too, insisted that the loan guarantees be conditioned on stringent economic reforms in Mexico and stressed that the United States should not attempt to manage the peso crisis alone.

Administration officials proposed to members of Congress yesterday that the

loan guarantees might be secured by rights to profits from the sale of Mexican oil reserves -- a notion that is sure to elicit controversy within Mexico. And Dole suggested loan guarantees to Mexico might carry a much steeper risk than the assurance extended to Israel. "I assume you'd charge Mexico as high as 10 percent because they are a greater risk," he told reporters following the meeting.

In the eyes of financial traders, final details of the package appeared to matter less than the solid signal of commitment from the United States.

"There was a major panic this week, and I think that was a bit of a climatic sell-off, where people threw up their hands and said maybe Mexico is going to disappear," said John Ford, vice president of the T. Rowe Price Latin American Fund in London.

The price of Mexican par bonds, which had gone from 56 cents on the dollar to about 45 cents on the dollar, was back to 53 cents yesterday, said John Hancock's John Daly.

The news of the loan guarantees also benefitted markets in other Latin American countries such as Argentina, Brazil, Chile and Peru, where stock markets suffered through one of their worst days in years on Tuesday. Jose A. Estenssoro, president of the privatized Argentine oil company YPF S.A. said the United States had no choice but to support Mexico through the crisis.

"It's not something that will have an effect on Argentina directly, but it probably will indirectly because it will give Mexico a chance of solving the very, very serious problems they have caused for everybody," he said.

If the Mexican government takes advantage of the guarantees offered by the Treasury Department on Thursday, it would draw U.S. commercial banks back into a loan market they have shied away from for more than a decade -- Latin American public debt.

Public sector loans badly burned industry giants such as Citicorp and BankAmerica Corp., when the Mexican government renegotiated loan terms in 1982. Several bankers said that while the Treasury Department's guarantees were reassuring, they hoped not to have to make the loans -- even though, they said, Mexico in 1995 is a fundamentally different country than Mexico in 1982.

Then, the government was much more closely involved in a closed Mexican economy that depended heavily on oil exports -- just when oil prices plummeted, depriving the government of a primary means of paying debts. Now, the Mexican government sports a balanced budget, a smaller debt burden and a more open economy with diverse sources of income.

Staff writers Helen Dewar, Brett D. Fromson and Jonathan D. Glater contributed to this report.

Statement With Congressional Leaders on Financial Assistance to Mexico

January 31, 1995

We agree that, in order to ensure orderly exchange arrangements and a stable system of exchange rates, the United States should immediately use the Exchange Stabilization Fund (ESF) to provide appropriate financial assistance for Mexico. We further agree that under Title 31 of the United States Code, Section 5302, the President has full authority to provide this assistance. Because the situation in Mexico raises unique and emergency circumstances, the required assistance to be extended will be available for a period of more than 6 months in any 12-month period.

The United States will impose strict conditions on the assistance it provides with the goal of ensuring that this package imposes no cost on U.S. taxpayers. We are pleased that other nations have agreed to increase their support. Specifically, the International Monetary Fund today agreed to increase its participation by $10 billion for a total of $17.8 billion. In addition, central banks of a number of industrial countries through the Bank for International Settlements have increased their participation by $5 billion for a total of $10 billion.

We must act now in order to protect American jobs, prevent an increased flow of illegal immigrants across our borders, ensure stability in this hemisphere, and encourage reform in emerging markets around the world.

This is an important undertaking, and we believe that the risks of inaction vastly exceed any risks associated with this action. We fully support this effort, and we will work to ensure that its purposes are met.

We have agreed to act today.

NOTE: The statement was announced jointly with Newt Gingrich, Speaker of the House of Representatives; Bob Dole, Senate majority leader; Thomas Daschle, Senate minority leader; Richard Armey, House majority leader; and Richard Gephardt, House minority leader.

Reuter News Service - United States January 31, 1995

HEADLINE: USA: **CLINTON MEXICO STRATEGY** SWITCH GETS SUPPORT

BYLINE: By William Scally

BODY:

WASHINGTON, Jan 31 (Reuter) - President Bill Clinton's decision to switch strategy on his Mexican financial rescue plan was welcomed on Tuesday by a relieved Congress which had balked at his earlier proposal to extend $ 40 billion in loan guarantees.

By abandoning efforts to seek congressional approval of the guarantees and drafting a plan that does not require congressional approval, Clinton avoided a long uphill battle.

Congressional leaders had been faced with the choice of submitting the plan to congressional votes -- and likely defeat -- or continuing to try to hammer out a more acceptable package while the peso crisis worsened.

Representative Jim Leach, an Iowa Republican who played a key role in trying to put together a guarantees package, said that in time Congress might well have acted on it but "it might well have taken a deepened crisis" and greater cost.

Initial congressional reaction to Clinton's new plan to use his executive authority to aid Mexico was positive, although there was some grumbling.

"In my opinion, most everybody's on board," Senate Republican Leader Bob Dole said.

Congressional leaders of both parties pledged on January 12 to do what was necessary to restore financial confidence in Mexico but the proposal to do this by in effect co-signing Mexican notes ran into immediate trouble.

Not the least of its problems was that the plan landed in a politically riven Congress where Democrats were still smarting from being ousted from power -- a time when "comity between the parties is not at the highest level," in Leach's words.

Republicans called on Democrats to step forward and support the president of their own party on the issue. Many Democrats believed that Republicans, controlling Congress for the first time in 40 years, should take responsibility.

"It was truly an unchosen issue at an unwelcome time," Leach, chairman of the House Banking Committee, told reporters.

Critics wanted to know why the United States was acting alone and why the

markets should not be allowed to function freely.

One sharp critic, Senator Phil Gramm wanted to know whether such a deal would win the approval of a canny "country banker" -- and concluded that it would not.

Intensive behind-the-scenes negotiations produced about 10 drafts of legislation, according to Leach.

At issue were conditions to be placed on the loan guarantees -- some of which raised questions about violating Mexican sovereignty.

Many Democrats wanted to reopen old Mexican labour and wages issues that had embroiled the North American Free Trade Agreement in 1993.

Republicans opposed provisions dealing with these issues but sought economic reforms.

Some members of both parties wanted to link the guarantees to Mexican action on illegal migration into the United States and even to ending trade with Cuba.

In the end the shape of the legislative package mattered little as it became clear that Congress could not act upon it in time to avert a possible Mexican default.

The New York Times, February 2, 1995

HEADLINE: **MEXICAN RESCUE** PLAN: WASHINGTON;
Rescue: Durable Or Brief?

BYLINE: By DAVID E. SANGER, Special to The New York Times

DATELINE: WASHINGTON, Feb. 1

BODY:

President Clinton's move to sidestep Congress and order emergency credits to Mexico halted a monthlong run on the peso, but it left Congressional critics and reluctant American supporters worrying that the bailout's success would prove temporary.

A debate over the solidity of the plan arose today as the International Monetary Fund met into the night in Washington and finally approved an emergency $17.8 billion in medium-term loans.

Officials said the money would be available immediately to help the Mexican Government keep from defaulting on $40 billion in bonds and other liabilities that come due this year. Approval came dispite bitter complaints by Germany and France that they had not been consulted by the White House and that the money might come out of aid to Eastern Europe and Russia.

On Capitol Hill, opponents of any American involvement in Mexico's bailout threatened hearings, focusing on what the Administration knew about Mexico's distress last year and how President Clinton diverted $20 billion in Treasury Department funds -- intended to stabilize the dollar on world markets -- to provide Mexico with emergency loans.

Not surprisingly, some of the harshest criticism came from Patrick J. Buchanan, the conservative columnist and the leader of the effort to kill any aid to Mexico.

"The looting of America, on behalf of the new world order, has begun," said Mr. Buchanan, who also opposed the North American Free Trade Agreement with Mexico and Canada a year ago. "Never again should a President be allowed to disregard the will of Congress to raid the U.S. Treasury to bail out Wall Street banks or a foreign regime."

Senator Phil Gramm, the Texas Republican and an expected contender for his party's nomination for President in 1996, said Mr. Clinton was "filling a bucket that is full of holes."

But the President's action was defended by an unlikely ally: Newt Gingrich, the Speaker of the Republican-controlled House of Representatives.

"The President exercised his authority," Mr. Gingrich said today. "He took a tremendous burden on his shoulders. He did what key leaders felt was necessary.

"I think people at a minimum should recognize the President had the courage to do what he was being told by the very sophisticated experts was vital to reinforce international markets."

To sell the President's action, Treasury Secretary Robert E. Rubin assured skeptical Republicans and Democrats on Capitol Hill that Mexico had agreed to fundamental economic reforms and would be held to those commitments.

The reforms, spelled out in a letter from Mexican officials to the I.M.F. last week, include a more independent central bank, controls on credit expansion, continued privatization of Government-owned industry and relaxation of many of economic controls, including prohibitions on foreign investment in Mexican banks.

But Treasury officials acknowledged today that while they had talked about the loan conditions in general terms with Mexico, there was nothing on paper. Already the conditions are being described in Mexico in far more lenient terms than they are in Washington.

For the American economy, the most important question is whether the bailout strengthens the peso. Its current level makes American goods 35 percent more expensive in Mexico than they were in December, and Mexican goods that much cheaper in the United States.

The current rate also seems to many economists to be likely to encourage far more illegal immigration across the border as Mexicans seek jobs that pay in dollars.

Mr. Clinton offered one of his most impassioned defenses of his action on Tuesday night in Boston.

"I know the surveys say that by 80 to 15, or whatever they said, the American people either didn't agree or didn't understand what in the world I'm up to in Mexico," he declared. "But I want to say to you, it might be unpopular, but in a time of transition it's the right thing to do."

Some of the harshest criticism of the Administration's action today came from European capitals, which were taken by surprise by the International Monetary Fund's decision -- under strong pressure from the White House -- to add $10 billion in aid to Mexico. That is in addition the $7.8 billion that the I.M.F. approved last week.

An I.M.F. official in Washington said some European governments were concerned that the fund's remaining resources might not be enough to deal with crises in other parts of the world.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

March 9, 1995

SECRETARY OF THE TREASURY

The Honorable Alfonse M. D'Amato
United States Senate
Chairman, Committee on Banking,
Housing and Urban Affairs
Washington, D.C. 20510-6075

Dear Mr. Chairman:

I look forward to appearing before your Committee tomorrow. The Department has cooperated and will continue to cooperate with the Committee's oversight of the use of the Exchange Stabilization Fund (ESF) to assist Mexico. This program directly affects our foreign policy and has been designed by Congress over the years to afford the Executive Branch considerable discretion. Many aspects of the program involve classified information. Nevertheless, we have indicated to your staff that we will make every effort to provide you and the Committee with relevant information concerning our ESF policy.

To date we have provided the Committee with 260 pages of unclassified information and 292 pages of classified information. On February 10, 1995, the Joint Economic Committee staff and representatives of the Senate Banking Committee staff reviewed the unclassified information. Copies of the unclassified material were provided to the Joint Economic Committee (JEC) on February 14, 1995 -- one copy for the express purpose of furnishing it to the Banking Committee at the request of your staff. The classified material for the Banking Committee and the JEC was delivered to the Office of Senate Security on March 3 in accordance with Senate procedure on handling classified documents.

These documents include all 1994 documents to or from the Secretary of the Treasury that relate to the issues you raised. In addition, these documents include all 1994 documents to or from the Undersecretary of the Treasury for International Affairs that relate to the issues you raised. Additional 1994 and 1995 documents within the limits we negotiated with the Joint Economic Committee and that were known to your staff will be produced. (You and Senator Mack, the Chairman of the JEC, wrote to me on February 24, 1995, requesting declassification of certain documents.)

Any delay that has occurred in this production relates to the practical limits of dealing with numerous requests from Congress for information at a time when the responsible officials

are also implementing the policy that the Congress wishes to oversee.

At one time key staff of your Committee may not have had the necessary clearances to view the classified documents. We offered to assist you in obtaining these clearances and have taken steps to provide this assistance.

Once the Committee's review of these materials and those we will provide in the coming days is completed, you may find that more information is needed by the Committee. If that is the case, we will continue to work with you and your staff to reach a principled accommodation of the needs of the Senate Banking Committee as it conducts oversight of a Treasury Department program.

Sincerely,

Bob Rubin

Robert E. Rubin

DEPARTMENT OF THE TREASURY
WASHINGTON

GENERAL COUNSEL

The Honorable Robert E. Rubin
Secretary of the Treasury
Washington, D.C. 20220

Re: Authority of the Secretary of the Treasury with Respect to Use of the Exchange Stabilization Fund for the Mexico Support Package

Dear Mr. Secretary:

As you requested, following is the opinion discussing your authority with respect to use of the Exchange Stabilization Fund for the Mexico Support Package.

I. The Proposed Program

On January 31, 1995, the President and Congressional leadership issued a joint statement in which they recognized that "unique and emergency circumstances" existed in the Mexican financial crisis. Acting in response to that crisis, and with the approval of the Congressional leadership, the President has proposed that the United States use the Exchange Stabilization Fund (hereinafter "ESF" or "the Fund") to provide a program of conditional financial assistance to Mexico. Under the program, up to $20 billion from the ESF would be used to support short-term swaps,[1] medium-term swaps having maturities of up to five years, and securities guarantees having maturities of up to ten years. The purpose of the swaps and guarantees is to assist Mexico in stabilizing its exchange and financial markets by providing resources to be used in such manner as to facilitate the redemption, financing or restructuring of Mexico's short-term debt obligations. This action is intended to help resolve Mexico's liquidity problems and to help stabilize the foreign exchange market.

To assure repayment of the swaps and guarantees in the unlikely event that Mexico fails to make timely payments on amounts due, the United States will require Mexico to establish a payments facility whereby the proceeds of Mexican oil exports will be made available to a Mexican Government account at the Federal Reserve Bank of New York, which would then use the

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[1] These include short-term swaps to be provided by the Federal Reserve Bank of New York, acting at the direction of the Federal Open Market Committee, for which the Treasury Department will provide backing.

proceeds to set off obligations owed to the United States. In addition, as added protection in the unlikely event of a default, the United States is requiring Mexico to maintain the value of the pesos it deposits with the United States for the medium-term swaps. Therefore, should the rate of exchange of the peso against the U.S. dollar drop during the time the United States holds pesos, Mexico would be required to provide the United States with enough additional pesos to reflect the rate of exchange prevailing at the conclusion of the swap.

In developing the proposed support program for Mexico, the United States has been working in concert with the International Monetary Fund (IMF). The IMF Board has approved up to $10 billion in additional assistance on top of its already unprecedented level of support, bringing the total IMF commitment up to $17.8 billion. In addition, the IMF is serving as a catalyst for support from other possible lenders.

II. The Exchange Stabilization Fund

a. Purpose

The ESF was established pursuant to section 10 of the Gold Reserve Act of 1934. As amended,[2] that legislation authorizes the Secretary of the Treasury, with the approval of the President, to deal in gold, foreign exchange, and other instruments of credit and securities "consistent with the obligations of the Government in the International Monetary Fund on orderly exchange arrangements and a stable system of exchange rates[.]" 31 U.S.C. 5302(b). In addition, the statute provides that "a loan or credit to a foreign entity or government of a foreign country may be made for more than six months in a twelve month period only if the President gives Congress a written statement that unique or emergency circumstances require the loan or credit be for more than six months." Id.

One of the main impetuses for the establishment of the Fund in 1934 was the concern that comparable funds established by European nations could have a significant impact on exchange markets to the detriment of the dollar. The ESF was established in large part to help the United States counteract those foreign pressures. See H. Rep. No. 292, 73d Cong. 2nd sess., 2 (1934). As originally enacted, section 10 of the Gold Reserve Act authorized the Secretary to take measures "for the purpose of

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[2] This section was codified at 31 U.S.C. 5302 as part of the permanent codification of Title 31 in 1982.

stabilizing the exchange value of the dollar."[3]

Since 1934, however, section 10 has been amended so that its focus has broadened from the stabilization of the dollar to include orderly exchange arrangements and a stable system of exchange rates. In general, this broadening reflects the evolution in the monetary system from 1934 to the present, and in particular the establishment of the international financial institutions in 1945 and the move away from the gold standard and a fixed exchange rate system.

b. History and Background

To enable the Secretary to carry out the provisions of section 10, Congress initially appropriated to the ESF in 1934 $2 billion of the increment resulting from the reduction in the weight of the gold dollar. The ESF was originally established as a two-year fund, subject to renewal by the President for an additional year. The President renewed the fund for an additional year in 1936, and the fund was subsequently renewed for successive two-year periods by Congress from 1937 until 1943.

In 1945, under the Bretton Woods Agreements Act, the ESF became a permanent, although much smaller, fund. That act authorized the Secretary of the Treasury to pay from the Fund $1.8 billion to the International Monetary Fund (IMF) as part of the United States subscription to that institution. The remaining $200 million in the Fund was intended to be "extremely useful in supplementing the work of the International Monetary Fund with respect to those countries that have close economic ties with the United States, and particularly those with which we now have bilateral stabilization agreements." See H. Rep. No. 629, 79th Cong., 2nd Sess. 3 (1945).

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[3] The Senate Banking Committee's report contains the following description of the original objectives of the ESF:

> It is interesting because [the ESF] is the most ingenious instrument ever developed in the monetary systems. It is equally effective in attack and defense. The reason for its establishment in this case is to defend the American dollar and our gold stocks against the invasion of similar funds operated by competitor nations. . . . The [British] equalization fund was so effective in driving up the dollar that we were forced off the gold standard. It is to prevent a repetition of this experience that we create the stabilization fund preparatory to the return to gold redemption.

S. Rep. No. 201, 73d Congress, 2d Sess. 2-3 (1934).

In 1962, an amendment to the Bretton Woods Agreements Act provided that any currencies or gold purchased by the United States from the IMF may be transferred from the General Fund of the Treasury to the ESF and administered as part of the ESF. Pursuant to the Special Rights Drawing Act of 1968, Special Drawing Rights (SDRs) allocated to the IMF or otherwise acquired by the United States are resources of the ESF.[4] In accordance with the Special Rights Drawing Act, SDRs can be monetized by the Secretary of the Treasury through the issuance of Special Drawing Rights Certificates to the Federal Reserve in an amount not to exceed the dollar value of the ESF's SDR holdings. As of September 30, 1993 (the date of the most recent annual report of the ESF), cumulative allocations to (i.e., liabilities of)[5] the United States totalled SDR 4,900 million (over $6.9 billion), and U.S. holdings (assets) of SDRs totalled SDR 6,488 million (about $9.2 billion).

Reflecting the termination of the fixed exchange rate system and the amendments to the Articles of Agreement to the IMF, section 10(a) of the Gold Reserve Act was amended in 1976 to specify that the ESF is to be utilized as the Secretary "may deem necessary to and consistent with the United States obligations in the International Monetary Fund." Pub. Law 94-564, 90 Stat. 2660, 2661. Section 10(b) was amended one year later to clarify further that those obligations are to maintain orderly exchange arrangements and a stable system of exchange rates, rather than to maintain any particular value of the dollar. Pub. Law 95-147, 91 Stat. 1227, 1229. In introducing the amendatory language, Senator Helms explained that ". . . the amendment would amend the Gold Reserve Act to specify that the purpose of exchange stabilization is not exclusively to "stabilize the exchange value of the dollar." Cong. Rec. S 16919 (Oct. 11, 1977)(emphasis added).

The 1977 amendments also clarified that in the event that

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[4] A Special Drawing Right (SDR) is an official reserve asset and a unit of account composed of a "basket" of the currencies of five IMF members having the largest exports of goods and services. These currencies are the U.S. dollar, Japanese yen, German mark, French franc, and U.K. pound. The valuation rate for SDR holdings and allocations is computed by the IMF based on the exchange rates of these currencies. The SDR holdings and allocations are revalued monthly based on the SDR valuation rate, and a gain or loss on that revaluation is recognized.

[5] These liabilities must be discharged only in the event of liquidation of or U.S. withdrawal from the SDR Department of the IMF or cancellation of SDRs.

the Secretary wishes to offer a loan or credit exceeding six months, he can do so if the President provides a written determination to Congress that unique or emergency circumstances make such a loan or credit necessary for a term greater than six months. The stated purpose of this amendment is to assure that, in general, ESF loans and credits are short-term, are used to counter market disorder, and do not undercut the IMF's role as the principal source of medium-term balance of payments financing. See S. Rep. No. 94-1295, 94th Cong. 2d Sess. 11 (1976). Indeed, in the normal course, measures to combat disorderly foreign exchange conditions can be completed in the short-term. Although the Exchange Stabilization Fund has been used to provide loans to foreign governments many times since its creation in 1934, it has not been used to offer loans or guarantees with maturities in excess of one year.[6]

Until fiscal year 1980, the administrative expenses associated with the international affairs function of the Treasury Department were financed from the resources of the ESF, pursuant to the Gold Act of 1934. In 1978, legislation was enacted providing that the Fund is not available to pay the administrative expenses of the Fund. Since that time, such administrative expenses have been funded by appropriations.

III. The President and the Secretary of the Treasury Have the Authority to Implement the Proposed Program Through the Exchange Stabilization Fund.

a. The Provision of Loans and Credits to Mexico is a Permitted Use of ESF resources.

In the Mexican support package, the ESF will be providing Mexico with three types of financing--short-term swaps, medium-term swaps, and securities guarantees with maturities of five to ten years. In a typical ESF swap transaction, a foreign country borrows U.S. dollars and agrees to repay them on a certain date at a specified rate of interest. In addition, at the time of the borrowing, Treasury takes possession of a corresponding amount of the foreign country's own foreign currency, which Treasury invests in the government securities of that country. Treasury returns the foreign currency to the country once the country has fully repaid the borrowed dollars, with interest at the specified

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[6] The President has invoked the authority under the ESF statute to exceed the usual six-month limit once before. In 1982, at the onset of the debt crisis, President Reagan notified Congress that emergency circumstances required the extension of loans and credits to Mexico for one year. Mexico fully repaid the loan on a timely basis.

rate.

Under the proposed package, the ESF will also agree to satisfy, or be answerable for, payments due holders of Mexican Government securities in the event the Mexican Government fails to make payment to these holders when due, up to an agreed specified amount. These guarantees thus operate like a line of credit, under which a set amount of money is made available to a borrower, to be drawn down if needed.

Although loans and credits are clearly permitted under the ESF, their purpose must be to maintain orderly exchange arrangements and a stable system of exchange rates, and not to serve as foreign aid. Therefore, in all swap transactions, Treasury has taken steps to assure that there is a source of repayment of the ESF.[7] For example, ESF swap agreements have frequently been tied to an IMF stabilization program, with drawings on the ESF "bridged" to drawings on the IMF.

The assured source of payment for the Mexican loans and guarantees will be the proceeds of Mexican oil sales, which will be made available to the United States under the payment facility described earlier. In addition to the oil payments facility, as explained above, the United States is also requiring Mexico to maintain the value of the pesos that it provides under the medium-term swap as a further measure of protection to the United States. The United States will also be charging Mexico interest rates for the medium-term swaps and fees for the securities guarantees that are designed to compensate the ESF for the risk of providing the funds, and to provide an incentive to Mexico to rely on private capital markets for its financing needs.

b. The Mexican Support Package is Consistent with the Obligations of the United States in the International Monetary

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[7] Lack of an assured source of repayment has been the reason underlying prior decisions of the Treasury Department to decline to use the ESF as a source of lending to a foreign country. For example, in considering possible assistance to Poland in 1989, the Treasury Department informed Congress that "it is prepared to consider positively a bridge loan to Poland <u>but could not make a commitment except in conjunction with an agreement between Poland and management of the IMF and identification of assured sources of repayment.</u> In addition to funds available under an IMF program, disbursements from the World Bank could be considered." <u>See</u> <u>United States Economic Programs for Poland and Hungary:</u> Hearings and Markup before the Committee on Foreign Affairs, 101st Cong., 1st Sess. 163 (1989)(emphasis added).

Fund on Orderly Exchange Arrangements and a Stable System of Exchange Rates.

The Articles of Agreement of the International Monetary Fund (the Articles) is the basic document that creates that institution, specifies its functions, and spells out the major obligations of its members. Article IV of the Articles ("Obligations Regarding Exchange Arrangements") establishes the general principles for members to follow in pursuing monetary policies that affect rates of exchange between the domestic currency and foreign currencies.

As originally drafted in 1945, Article IV established a system of fixed exchange rates. The Fund required each member to state a par value for its currency in terms of gold, or in terms of the U.S. dollar of fixed gold value, and to maintain exchange rates within a narrow band. Largely at the instigation of the United States, Article IV was amended in 1978, to remove this obligation.[8] Under the present Article IV, members are given the freedom to choose whatever exchange arrangements they prefer so long as they are consistent with the basic guidelines set out in Article IV, section 1. The IMF oversees the exchange arrangements of its members through a monitoring process referred to in section 3 of Article IV as "surveillance."

Article IV provides that the basic obligation of the members with respect to exchange arrangements is "to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates." In connection with this obligation, each member in particular commits under Article IV to seek, inter alia, "to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions." This is consistent with the language that was adopted in the 1977 amendment of section 10 of the Gold Reserve Act, which replaced the long-standing reference to maintaining

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[8] The House Banking Committee noted in 1976 that it strongly supported this change as well. In its report accompanying amendments of the Bretton Woods Agreements Act, it stated: "This abandonment of fixed, in favor of floating, exchange rates reflects a general recognition that, at least under present economic conditions, attempts to maintain fixed exchange rates are futile and counterproductive. A major objective of the United States in negotiating international monetary reform was the amendment of Article IV to permit greater flexibility of exchange rates. . . This Committee has long supported this objective, and welcomes the success of the administration in negotiating a new Article IV embodying this principle." H. Rep. No. 94-1284, 94th Cong., 2d Sess. 4 (1976).

the value of the dollar. That amendment clarified that the purpose of the Fund was to deal in gold, foreign exchange, and other instruments of credit consistent with the obligations of the United States in the IMF "regarding orderly arrangements and a stable system of exchange rates." Pub. L. 95-147, sec.4.

The Mexico support package is clearly consistent with these purposes. The current Mexican financial crisis is a liquidity crisis that has had a significant destabilizing effect on the exchange rate of the peso, with consequences for the overall exchange rate system. See generally Press Conference of Michel Camdessus, Managing Director, IMF (Feb. 2, 1995)(hereinafter Camdessus Press Conference). The spill-over effects of inaction in response to the peso crisis would be significant for other emerging market economies, particularly those in Latin America, as well as for the United States.[9] As IMF Managing Director Camdessus stated in his explanation of the IMF's current role in assisting Mexico, "as the central institution of international monetary cooperation, [the IMF] had the responsibility not only to provide financial support for Mexico's program and thereby to give confidence to Mexico, but also to respond to the systemic implications of the Mexican crisis and to give confidence to the international financial system." Id. (Emphasis added.) (See also remarks of Chairman Greenspan and Under Secretary of State Tarnoff before the House Banking Committee, Feb. 9, 1995.) Similarly, even if the ESF remained limited to its original relatively narrow purpose of maintaining the value of the dollar, the Mexico support program would be consistent with that purpose.[10]

c. The President has broad discretion to make medium-term loans and credits available under the ESF for the purposes of section 10.

(i) Congress has not limited the discretion of the President and, acting with the President's approval, the Secretary of

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[9] See "Worries About U.S. Aid Package and Defaults in Mexico Depress Prices in Emerging Markets," Wall Street Journal, Feb. 17, 1995.

[10] If recent foreign exchange market activity is any indication, the ability of the peso crisis to have a negative impact on the exchange rate of the U.S. dollar may already be in evidence. See "D-Mark rises as Mexican Financial Crisis Hits Dollar," Financial Times, Feb. 17, 1995 at 1; "Dollar Falls on Fears in Peso Crisis: U.S. Financial Toll Seen if Bailout Fails," New York Times, February 17, 1995; "Dollar Plunges Against Mark and Yen; Mexico, Rush to German Currency Cited," Wall Street Journal, Friday, Feb. 17, 1995.

the Treasury to use the ESF.

Since its inception, the ESF has been operated at the complete discretion of the Secretary of the Treasury, acting with the approval of the President. During the House debates on the 1934 legislation, Congressman Dies, a member of the Coins, Weights and Measures Committee, led off the discussion by explaining in detail the objectives of the proposed legislation. Concerning the operations of the ESF, he described the operation of the British exchange equalization fund, which, he maintained, had already greatly increased the Bank of England's gold and foreign exchange reserves. He noted that the British fund

> began to operate at once with the greatest secrecy. Its operations are under the law of England veiled in secrecy, and there is no way of ascertaining its activities except by appraising the results . . . It is imperative that we resist the operations of the [British] equalization fund. The only feasible method by which this can be accomplished is to establish a similar fund, and to clothe the Secretary of the Treasury and the President with equal powers and resources. . . . [T]he Parliament decided that the success of the [British] fund would be destroyed if its operations were not veiled in the greatest secrecy. For the same reason Congress will have to impose confidence in the honesty and integrity of the Secretary of the Treasury and the President.

78 Cong. Rec. 966 (January 20, 1934).

Since 1934, Congress has held a number of hearings concerning the ESF, and considered various proposals to limit the President's or the Secretary of the Treasury's authority with regard to the Fund. For example, in 1934, there were a number of proposals to vest control of the ESF in a five-member board, similar to the British Fund, which was under the control of three individuals. See H. Rep. 292, 73d Cong., 2nd Sess., Part 2 (1934). These proposals were defeated in recognition of the importance of giving the Secretary of the Treasury the utmost discretion and confidentiality possible.

In more recent times, questions have been raised about the breadth of the Secretary of the Treasury's discretion with regard to the Fund. On at least two occasions, the House Banking Committee has held hearings to examine the role of the ESF and, in particular, the authority of the Secretary of the Treasury. See, e.g., Exchange Stabilization Fund and Argentina: Hearings Before the Subcommittee on International Trade, Investment and Monetary Policy of the Committee on Banking, Finance and Urban Affairs, House of Representatives, 98th Cong., 2d Sess. (May 1 and 15, 1984); and Review of Treasury Department's Conduct of

International Financial Policy: Hearing Before the Committee on Banking and Finance and Urban Affairs, House of Representatives, 101st Cong., 2d Sess. (August 14, 1990). These hearings did not result in any changes being made to the Secretary of the Treasury's authority with regard to the ESF.[11] The Secretary's decisions with respect to the manner in which fund resources are to be deployed remain final and unreviewable by any other "officer or employee of the Government." 31 U.S.C. 5302(a)(2).

Given the purpose of the ESF as a means of maintaining order in exchange markets and its genesis as a tool for counteracting similar funds held by other countries, it is entirely reasonable that Congress has vested complete discretion in the Secretary of the Treasury and the President for the operation of the Fund. As the chief financial policy official of the U.S. Government, the Secretary of the Treasury is uniquely situated in the Government to make the complex judgments necessary to determine the need for intervention in currency markets at any particular time. Moreover, as the official primarily responsible for the conduct of the foreign affairs of the United States, the President has the expertise and perspective to determine whether particular circumstances are unique or sufficiently serious to warrant longer-term efforts at stabilization.[12]

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[11] There have also been several occasions where Congress has examined the ESF and decided against making any major changes to the basic operation of the Fund. In 1939, when Congress enacted a requirement that the Secretary of the Treasury provide an annual audit of the Fund to Congress, the Senate Committee Report stated that "secrecy as to the day-to-day operations of the fund is necessary to its success. That the Congress may be informed as to its operations, however, the bill provided that a report of the annual audit of the fund be submitted to Congress as well as to the President." H. Rpt. No. 406, 76th Cong., 1st Sess. (1939) at 1. In 1976, the Congress considered and rejected a proposal to put the ESF into the budget. See Exchange Stabilization Fund: Hearing before the Task Force on Tax Expenditures and Off-Budget Agencies of the House Budget Committee, 94th Cong., 2d Sess., (Feb. 18, 1976). The Congress has also rejected a proposal to require a GAO audit of the Fund. Although two years later the administrative expenses of the Fund were put into the budget, the Fund itself continues to be outside the budget and is not audited by the GAO. See Pub. Law 95-612.

[12] The latitude afforded the President in this context is similar to the discretion he has been granted under another statute that deals with unusually serious situations, the International Emergency Economic Powers Act. Even in that context, where the range of possible Presidential action is

(ii) Congress has not imposed any term limits on loans or credits made under the ESF.

Similarly, Congress has not placed any term limits on loans or credits made under the ESF. Under the 1977 amendment to the statute, the Secretary may provide loans or credits in excess of six months if the President provides Congress with a written statement that unique or emergency circumstances require such longer-term measures. Thus, Congress has not limited the President's ability to take action, but has asked only that the President recognize that extraordinary measures be reserved for extraordinary situations. As Representative Hamilton observed at a 1989 House hearing on possible U.S. financial assistance to Poland and Hungary, the President and the Secretary of the Treasury plainly have the legal authority to use the ESF for longer-term assistance in certain circumstances. See United States Economic Programs for Poland and Hungary: Hearings and Markup before the Committee on Foreign Affairs, 101st Cong., 2nd Sess. 168 (1989). Ultimately, the Treasury Department determined that the particular circumstances at hand in the case of Poland did not warrant use of the ESF. See id. at 175.

The extension of loans and credits to Mexico under the proposed support program is consistent with what Congress intended when it amended the ESF provision in 1977 to require Presidential notification in the event that longer-term loans or credits were deemed necessary. Although Congress has expressed a preference that the ESF be used primarily for shorter-term lending, it has acknowledged that longer-term efforts are sometimes necessary. The Senate Banking Committee explained that it

> recognizes that there may be circumstances where longer-term ESF credits may be necessary, and the amendment provides for that possibility. But the Committee intends, and the amendment expressly provides, that such longer-term financing be provided only when there are unique and exigent circumstances. As indicated by Treasury, these would include natural disasters, trade embargoes, unforeseen economic developments abroad, political assassinations, or other catastrophic events.

S. Rep. No. 94-1295, 94th Cong., 2nd Sess. 11 (1976) (quoting letter from Under Secretary of the Treasury for Monetary Affairs Edwin H. Yeo to Adlai E. Stevenson, Sept. 1, 1976)(emphasis added). Given both the current financial crisis in Mexico and

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broader than under the ESF, Congress has not limited the President's ability to invoke the authority of the statute when he determines that it is necessary to do so.

the political difficulties that country has faced in the past few months, the criteria for longer term actions suggested by the Treasury Department in 1976 and implicitly adopted by the Senate Banking Committee are easily satisfied in this case.

The flexibility to retain a longer-term option for the purpose of addressing serious exchange market disruptions is critical. The ESF plays an important complementary role to the Federal Reserve Board, which also has the authority to intervene in foreign exchange markets in the interest of maintaining their stability. However, the Federal Reserve Board is more limited than the ESF in the types of transactions it can undertake. In the context of 1976 hearings concerning a proposal to change the budget treatment of the ESF, former Board Chairman Paul Volker explained the differences between the Board's and the ESF's powers in this area to Representative Sam Gibbons, Chairman of the Task Force on Tax Expenditures and Off-Budget Agencies, Committee on the Budget:

> . . . Federal Reserve operations are more limited than the potential operations of the ESF. The ESF, although its resources are much smaller, can respond in a greater variety of ways to contingencies not envisaged in guidelines for Federal Reserve operations. The ESF can, for instance, engage in transactions with countries that may not be included in the System's overall swap network. Since ESF financing can more easily be arranged on an ad hoc basis instead of as part of an overall network of credits, as is the case for the Federal Reserve, the ESF can respond more flexibly to unusual or special circumstances, attaching such conditions and specifications to those financing as may be appropriate to each operation. The ESF has also been assigned a number of significant functions with respect to SDRs. <u>It can undertake operations to deal with unusual market situations which might entail a longer-term exposure than is appropriate for the System under the swap arrangements.</u> And, it can potentially supplement the amount of financing that is available to any country under System swap arrangements.

<u>Exchange Stabilization Fund:</u> Hearing before the Task Force on Tax Expenditures and Off-Budget Agencies of the Committee on the Budget, House of Representatives, 94th Congress, 2d Sess. 81 (1976)(emphasis added).

In its Report accompanying the 1976 bill, the Senate Banking Committee expressed concern that, given its size, the ESF could be used as a potential source of bilateral assistance for foreign

exchange purposes outside the IMF.[13] The Committee went on to explain that

> to the extent that such assistance permits a country to avoid necessary changes to its economic policies, it undermines the IMF's goal of inducing necessary adjustments in policy to promote orderly economic growth and stability. In order to insure that ESF operations are not inconsistent with the goals of the IMF, the Committee has adopted an amendment emphasizing the intended short-term nature of ESF lending. <u>The goal is for the United States to place primary reliance on the IMF and to confine foreign exchange lending operations outside the IMF to short-term operations.</u>

S. Rep. No. 94-1295, 94th Cong., 2d Sess. 11 (1976)(emphasis added).

As explained above, the United States is complementing rather than supplanting the IMF in providing loans and credits to Mexico. The IMF plays a catalytic role in helping members finance balance of payments shortfalls, and a safety net role in the event that other sources of assistance are inadequate. The IMF has endorsed the President's Mexico support package. Recognizing the magnitude of the peso problem, and the substantial resources that will be necessary to address it, the IMF is playing a significant role in helping Mexico marshall funds from other sources. <u>See</u> Camdessus Press Conference at 8-9. In response to a question concerning the possibility of future

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[13] In response to a question from the Senate Banking Committee as to why the ESF should not be restricted to short-term lending exclusively, so that it does not compete with the IMF, then-Under Secretary of the Treasury for Monetary Affairs Edwin H. Yeo explained:

> Although the ESF is likely to be used primarily for short-term lending, a statutory requirement that it be used for short-term lending exclusively would not be appropriate and would unnecessarily impair U.S. flexibility, especially in unforeseen circumstances, in implementing our international monetary policy. While operations have on occasion been used to complement IMF lending, no question of "competition" with the IMF would be expected to arise. The ESF--with such limited resources--in fact could not "compete" with the IMF as a major source of balance of payments financing.

<u>See</u> <u>Amendments of the Bretton Woods Agreements Act</u>: Hearing Before the Subcommittee on International Finance of the Committee on Banking, Housing and Urban Affairs, U.S. Senate, 94th Cong., 2d Sess. 158 (1976).

serious currency difficulties in other countries, Mr. Camdessus said:

> It is true that the Mexican case is truly exceptional for the United States of America; the authorities of our host country have put that very clearly. This gives the IMF an added obligation to be ready to step in, at least as convincingly, if not more, in cases where we could not expect the same kind of support from the United States of America. We are working to this effect. As I have already said, we now have the appropriate means for doing that, but we also urgently need to convince our shareholders to equip us better for whatever crisis situation might emerge.

Camdessus Press Conference, Feb. 2, 1995, at 10.

IV. Conclusion

Longer term assistance is clearly required in this instance. The Mexican peso crisis has erupted with such suddenness and in such magnitude as to render the usual short-term approaches inadequate to address the problem. While the problem is caused largely by a tremendous over-hang of short-term debt, longer-term solutions are necessary to take into account Mexico's debt servicing capacity and avoid further pressure on the exchange rate of the peso.

As shown above, the language of the ESF statute clearly permits such assistance. In the more than sixty years of the ESF's existence, Congress has never seen any reason to limit the President's ability to draw on the Fund's resources, provided that he did so in accordance with the basic purposes of section 10 of the Gold Reserve Act, as amended and presently codified in title 31. To the contrary, Congress has considered and rejected various proposals that would have limited the President's or the Secretary of the Treasury's authority to act, or subjected them to greater Congressional oversight. The highly technical and complex area of foreign exchange and exchange market stability blends important considerations of monetary and foreign policy. It is an area that is properly left to the discretion of the President and, acting with the President's approval, the Secretary of the Treasury.

Sincerely,

Edward S. Knight

Edward S. Knight
General Counsel

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

March 10, 1995

The Honorable Alfonse M. D'Amato
United States Senate
Washington, D.C. 20510-3202

Dear Senator D'Amato:

I am enclosing a copy of a memorandum from Assistant Attorney General Walter Dellinger to me in which the Office of Legal Counsel (OLC) at the Justice Department expresses its concurrence with our view that the President and the Secretary of the Treasury have the legal authority under 31 U.S.C. 5302 to use the Exchange Stabilization Fund to provide loans and credits to Mexico pursuant to the Mexican support package. The memorandum includes a discussion of the basis for OLC's opinion.

Sincerely,

Michael B. Levy

Michael Levy
Assistant Secretary
(Legislative Affairs)

Enclosure

U. S. Department of Justice

Office of Legal Counsel

Office of the
Assistant Attorney General

Washington, D.C. 20530

March 2, 1995

MEMORANDUM TO EDWARD S. KNIGHT
GENERAL COUNSEL
TREASURY DEPARTMENT

From: Walter Dellinger
Assistant Attorney General

Re: Use of the Exchange Stabilization Fund To Provide Loans and Credits to Mexico

On January 31, 1995, the President proposed to use the Treasury Department's Exchange Stabilization Fund (the "ESF" or the "fund") to provide $20 billion of loans and credits to Mexico as part of a financial support package for that country (the "support package"). On February 21, 1995, the Treasury Secretary (the "Secretary") signed a series of agreements with the Mexican government implementing the support package. Prior to the execution of the agreements, we orally advised your office that, in our view, the President and the Secretary could use the ESF in the manner contemplated by the President when he proposed the support package. We also provided comments on drafts of a legal opinion. prepared by your office for the Secretary, regarding such use of the ESF. This memorandum confirms the oral advice we provided to your office. It also confirms that we have reviewed the final version of your legal opinion, and that we concur in your conclusion that the President and the Secretary have the authority to use the ESF in connection with the support package. We would like to take this opportunity to set forth briefly the basis for our determination that your conclusion is correct.

I. Background

A. <u>The Support Package</u>

Under the support package,[1] the loans and credits to Mexico from the ESF will take three forms: (i) short-term currency "swaps" through which Mexico will borrow U.S. dollars in exchange for Mexican pesos for 90 days; (ii) medium-term currency swaps through which Mexico will borrow U.S. dollars for up to five years; and (iii) guaranties through which the United States will back-up Mexico's obligations on government securities for up to ten years. The ESF loans and credits will supplement billions of dollars of financial assistance that will be provided to Mexico by the International Monetary Fund ("IMF") and other lenders. As a whole, the support package is intended to help Mexico resolve its serious economic problems, which, in turn, have resulted in a significant destabilization of the Mexican peso and have threatened to disrupt the international currency exchange system.

B. <u>The ESF</u>

The ESF was established by Congress in 1934 pursuant to section 10(a) of the Gold Reserve Act, which is now codified at 31 U.S.C. § 5302. The ESF "is under the exclusive control of the Secretary," whose use of the fund is "[s]ubject to approval by the President." <u>Id.</u> § 5302(a)(2). Initially, the statute provided that the ESF was to be used "[f]or the purpose of stabilizing the exchange value of the dollar." Act of Jan. 30, 1934, ch. 6, § 10(a), 48 Stat. 337, 341 (1934).[2] That is no longer the case. The provision governing the Secretary's use of the ESF now states:

> Consistent with the obligations of the Government in the International Monetary Fund on orderly exchange arrangements and a stable system of exchange rates, the Secretary or an agency designated by the Secretary, with the approval of the President, may deal in gold, foreign exchange, and other instruments of credit and securities the Secretary considers necessary. However, a loan or credit to a foreign entity or government of a foreign country may be made for more than 6 months in any 12-month period only if the President gives Congress a written statement that unique or emergency circumstances require the loan or credit be for more than 6 months.

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[1] Our understanding of the support package is derived from the following sources: (i) public information released by the Treasury Department when the President proposed the support package on January 31, 1995; (ii) the Secretary's testimony on the support package at a February 9, 1995 hearing before the House Committee on Banking and Financial Services; (iii) public information released by the Treasury Department when the Secretary signed the agreements implementing the support package on February 21, 1995; and (iv) your legal opinion for the Secretary.

[2] <u>See also</u> H.R. Rep. No. 292, 73d Cong., 2d Sess. 2 (1934).

31 U.S.C. § 5302(b).

The first sentence of the current provision stems from 1976 amendments to section 10(a) of the Gold Reserve Act. Those amendments eliminated the requirement that the ESF be used "for the purpose of stabilizing the exchange value of the dollar," and provided instead that the fund was to be used consistent with U.S. obligations in the IMF. See Pub. L. No. 94-564, 90 Stat. 2660, 2661 (1976).[3] The second sentence of the current provision stems from a 1977 amendment to section 10(a) of the Gold Reserve Act. See Pub. L. No. 95-147, 91 Stat. 1227, 1229 (1977).[4] The intention of that amendment was to ensure that longer-term lending from the ESF was limited to "unique or exigent circumstances."[5]

II. Statutory Analysis

In carrying out the support package, the Secretary will be "deal[ing] in gold, foreign exchange, and other instruments of credit and securities" within the meaning of 31 U.S.C. § 5302.[6] The first question in the statutory analysis is whether use of the ESF in connection with the support package is "[c]onsistent with the obligations of the Government in the

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[3] The 1976 amendments to section 10(a) of the Gold Reserve Act were part of a law that modified the Bretton Woods Agreements Act -- the statute that implements U.S. obligations in the IMF. Congress concluded that those modifications were necessary because of an early 1970s shift in international monetary arrangements from fixed to variable currency exchange rates. As a result of that shift, the United States was not, in 1976, pursuing a policy "to stabilize the exchange value of the dollar at any par value, or fixed rate." H.R. Rep. No. 1284, 94th Cong., 2d Sess. 13-14 (1976). Rather, its policy was "to permit a wide degree of fluctuation for the exchange value of the dollar, and to conduct exchange rate policy subject only to [its] obligations" in the IMF. Id. at 14. The modifications to the Bretton Woods Agreements Act authorized the U.S. to "accept amendments to the IMF Articles of Agreement . . . [that] permitted [members] to choose any . . . exchange arrangement, fixed or floating, subject to a general obligation to avoid exchange rate manipulation, promote orderly economic, financial, and monetary conditions, and foster orderly economic growth with reasonable price stability." S. Rep. No. 1295, 94th Cong., 2d Sess. 2-3 (1976) [hereinafter 1976 Senate Banking Comm. Report]. When the ESF statute was first drafted, the dollar was pegged to a fixed rate. Therefore, a change to the statute that corresponded with changes in U.S. and international monetary policy was required. Simply put, the original language from 1934 specifying that the ESF was to be used to stabilize the dollar had become "anachronistic" by 1976. H.R. Rep. No. 1284, supra, at 14.

[4] The amendment was originally proposed in the Senate as part of the 1976 amendments to section 10(a). See 1976 Senate Banking Comm. Report at 11; see also 123 Cong. Rec. 33,219-20 (1977) (statement of Sen. Helms) (introducing amendment requiring that the President notify Congress of any use of the ESF for loans of greater than six months, and commenting that the amendment had been proposed in connection with Senate consideration of the 1976 amendments).

[5] See 1976 Senate Banking Comm. Report at 11.

[6] The short and medium-term swap arrangements are loans, in that Mexico will borrow dollars from the United States in exchange for pesos. The guaranties of Mexico's government securities obligations essentially serve as a line of credit from the United States on which Mexico can draw in the event that it cannot satisfy those obligations.

International Monetary Fund on orderly exchange arrangements and a stable system of exchange rates." We believe that it is. Again, the stated purpose of the support package is to stabilize the value of the Mexican peso and prevent disruption of international currency exchange arrangements -- which is entirely in keeping with U.S. obligations in the IMF.[7] Moreover, since the statute states that the Secretary may use the ESF as he "considers necessary," it is up to the Secretary (subject to the President's approval) to decide when such action is consistent with U.S. obligations in the IMF. The Secretary's decisions in that regard "are final." 31 U.S.C. § 5302(a)(2). In short, in implementing the support package, the Secretary has exercised the discretion with which Congress has charged him.[8]

The plain language of the statute also provides the President and the Secretary with the legal authority to use the ESF for the currency swaps of up to five years and the guaranties of up to ten years. The statute explicitly states that loans or credits with repayment terms of more than six months can be extended from the ESF "if the President gives Congress a written statement that unique or emergency circumstances require the loan or credit be for more than 6 months." When the support package was proposed on January 31, 1995, the President announced that he had determined that the financial crisis in Mexico constituted unique and emergency circumstances.[9] The President made his announcement in a joint statement that he issued with the congressional leadership, who expressed their

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[7] As your legal opinion for the Secretary notes, Article IV of the IMF Articles of Agreement requires the United States to "collaborate with the [IMF] and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates." Members are to fulfill that obligation "by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions." See also supra note 3 (discussing 1976 modifications to federal statute that implements U.S. obligations in the IMF).

[8] At the February 9, 1995 hearing on the support package that was held by the House Banking and Financial Services Committee, Representative Barr suggested that, when considering possible financial assistance to Poland in 1989, the Treasury Department had concluded that it was unlawful to use the ESF for purposes other than to stabilize the dollar. Any such conclusion would have contravened the express terms of the ESF statute. In any event, that is not what Treasury concluded in that case. Rather, Treasury said that it would not be "improper or illegal" to use the ESF to extend a "bridge loan" to Poland if the Secretary "concluded that such a loan would be consistent with U.S. obligations in the IMF and was necessary." United States Economic Programs for Poland and Hungary: Hearings and Markup Before the House Comm. on Foreign Affairs, 101st Cong., 1st Sess. 175 (1989). Treasury determined that, in the particular circumstances of that case, "it [was] highly unlikely that such a conclusion could be justified." Id. Moreover, in the absence of a commitment from the IMF, Poland had no means of guaranteeing repayment of any ESF loan. In Treasury's view, the use of the ESF in such circumstances would be "much closer to foreign aid." Id. at 149. See also id. at 162-63. Therefore, Treasury decided to seek legislative authorization for assistance to Poland. Id. at 148-49. Here, by contrast, the IMF is playing an integral role in the support package, and (as discussed below at note 12), the ESF loans and credits will have an assured source of repayment.

[9] It is our understanding that the President will promptly provide Congress with written notice of that determination, as required by the ESF statute.

collective view that the use of the ESF in connection with the support package was both lawful and necessary.[10]

The authority of the President and the Secretary to use the ESF as a source of loans or credits of more than six months has been invoked once before in the years since the statute was amended in 1977 to provide expressly for such action. That came in 1982, when President Reagan, acting in response to an earlier instance of financial turmoil in Mexico, turned to the ESF to provide loans to Mexico with maturities of up to one-year. In accordance with the statutory requirements, President Reagan notified Congress in writing on September 8, 1982 that he had determined on August 24, 1982 that unique and exigent circumstances required that the ESF loan to Mexico have repayment terms in excess of six months.[11] It is true that no prior precedents under the ESF involved loans or credits of maturity lengths and dollar amounts comparable to those at issue in the support package.[12] That said, such use of the ESF is clearly authorized by the language of the statute.

We find it telling that when Congress was considering what eventually became the 1977 amendment to section 10(a) of the Gold Reserve Act, it apparently gave some thought to restricting use of the ESF to short-term lending exclusively so that the ESF would not compete with the IMF -- which was seen as the primary vehicle for longer-term lending. In fact, a question to that effect was posed to a Treasury Department official during the course of a Senate Banking Committee hearing that explored, among other things, the relationship

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[10] In pertinent part, the joint statement was as follows:

> We agree that, in order to ensure orderly exchange arrangements and a stable system of exchange rates, the United States should immediately use the Exchange Stabilization Fund (ESF) to provide appropriate financial assistance for Mexico. We further agree that under Title 31 of the United States Code, Section 5302, the President has full authority to provide this assistance Because the situation in Mexico raises unique and emergency circumstances, the required assistance to be extended will be available for a period of more than 6 months in any 12-month period . We must act now in order to protect American jobs, prevent an increase flow of illegal immigrants across our borders, ensure stability in this hemisphere, and encourage reform in emerging markets around the world. This is an important undertaking, and we believe that the risks of inaction vastly exceed any risks associated with this action. We fully support this effort, and we will work to ensure that its purposes are met

Statement with Congressional Leaders on Financial Assistance to Mexico, 31 Weekly Comp Pres. Doc 155 (Jan 31, 1995).

[11] See Letter from President Reagan to Thomas P O'Neill, Jr , Speaker of the House of Representatives, Sept. 8, 1982, reprinted in United States Economic Programs for Poland and Hungary: Hearings and Markup Before the House Comm. on Foreign Affairs, 101st Cong., 1st Sess. 161-62 (1989).

[12] It is our understanding, however, that other critical elements of the loans and credits to Mexico in connection with the support package -- in particular, the structure of the agreements and the existence of an assured source of repayment -- are fully consistent with past practice under the ESF

between lending under the ESF and lending under the IMF.[13] In response, the Treasury official stated:

> [A] statutory requirement that [the ESF] be used for short-term lending exclusively would not be appropriate and would unnecessarily impair U.S. flexibility, especially in unforeseen circumstances, in implementing our international monetary policy . . . . [I]t is conceivable that, in some instances, use of the ESF for a somewhat more extended period may be necessary. External factors (such as natural disasters, trade embargoes, unforeseen economic developments . . .) may lead a country which has obtained a short-term credit from the ESF to seek an extension of that credit. It is also conceivable that political assassination or other unanticipated catastrophic event might justify a longer extension of credit, and the possibility of ESF operations in such cases should not be excluded. In none of these cases would the ESF compete with the IMF, and in all of these cases it well may be in the U.S. interests to provide somewhat more extended ESF financing.[14]

That sentiment carried the day, and ultimately found its way into the statute through the 1977 amendment. The report of the Senate Banking Committee on what turned out be that amendment puts its succinctly:

> The Committee recognizes that there may be circumstances where longer-term ESF credits may be necessary, and the amendment provides for that possibility. But the Committee intends, and the amendment expressly provides, that such longer-term financing be provided only where there are unique or exigent circumstances. As indicated by Treasury, these would include natural disasters, trade embargoes, unforeseen economic developments abroad, political assassinations, or other catastrophic events. In none of these cases should the ESF compete with the IMF, however, and every effort should be made to bring all medium and longer-term financing within the framework of the IMF or other appropriate multi-lateral facilities.[15]

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[13] Amendments of the Bretton Woods Agreements Act: Hearing Before the Subcomm. on International Finance of the Senate Comm. on Banking, Housing and Urban Affairs, 94th Cong., 2d Sess. 157 (1976).

[14] Id. at 158 (statement of Edwin H. Yeo, III, Under Secretary for Monetary Affairs, Department of the Treasury).

[15] 1976 Senate Banking Comm. Report at 11 (footnote omitted). The Committee echoed that theme elsewhere in the report:

> [The] amendment would not bar the United States from making longer-term credits to foreign countries for exchange market intervention, but it would insure that such longer-term credits are not extended unless the President finds that unique or exigent circumstances exist, such as the unavailability of IMF or other international financial resources for that purpose. By

The Mexican economic crisis would appear to be a prime example of the type of unique or exigent circumstances that the Senate Banking Committee had in mind when crafting the 1977 amendment: according to some observers, Mexico's financial troubles were exacerbated by the shocking assassinations in 1994 of two key Mexican political leaders and the unanticipated strife in the Chiapas region of Mexico.[16] Furthermore, the support package appears to honor the Committee's admonition that longer-term use of the ESF not "compete" with the IMF. It is our understanding that the loans and credits from the ESF complement the substantial financial assistance that the IMF and other lenders are furnishing to Mexico. Indeed, the Treasury Department has worked closely with the IMF in fashioning the support package.

Finally, it is worth noting that Congress plays an important oversight role with respect to use by the President and the Secretary of the ESF for loans of more than six months. As the Senate Banking Committee described Congress' function, "[t]he requirement that the President report to the Congress on any such longer-term financing will provide the Congress with an opportunity to scrutinize such longer-term ESF credits and take appropriate steps to insure that they are consistent with U.S. interests and U.S. obligations under the IMF."[17] In that role, Congress has, over the years, considered various proposals to cabin the authority of the President and the Secretary under the ESF statute. Those proposals have been repeatedly rejected, however.[18] This history reflects the judgment of Congress that the President and the Secretary should retain the flexibility to use the ESF, as they consider necessary, to respond promptly to sudden and unexpected international financial crises that

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> helping to keep ESF financing short-term in nature, the amendment would help insure consistency between use of the ESF and U.S. obligations as a member of the IMF.

Id. at 17-18.

[16] See Henry A. Kissinger, Aiding Mexico is Not Just Economics -- It's National Security, L.A. Times, Jan. 29, 1995, at M2; Tod Robberson, Mexico's Meltdown, Wash. Post, Jan. 8, 1995, at A24; see also Time, Jan. 9, 1995, at 44.

[17] Senate Banking Comm. Report at 11.

[18] For example, in 1984, then-Representative (and now Senator) Brown introduced legislation that he said was designed to restore the ESF to its original purpose, and thereby prevent the ESF from being used as a "slush fund to bail out American banks" that make bad loans abroad. See Exchange Stabilization Fund and Argentina: Hearings Before the Subcomm. on International Trade Investment and Monetary Policy of the House Comm. on Banking, Finance and Urban Affairs, 98th Cong., 2d Sess. 129 (1984) (statement of Rep. Brown). Other members of the House took issue with the premises underlying Representative Brown's proposal. See id. at 135-36 (statement of Rep. Neal); id. at 138-39 (statement of Rep. Leach); id. at 156-57 (statement of Rep. Barnard). In the end, Congress did not act on the proposal. Similarly, in 1990, a House Committee held a hearing that was intended, among other things, to probe whether the ESF had been used "to circumvent the appropriations process" through which financial assistance to foreign countries is normally tendered. See Review of Treasury Department's Conduct of International Financial Policy: Hearing Before the House Comm. on Banking, Finance and Urban Affairs, 101st Cong., 2d Sess. 2 (1990) (statement of Rep. Gonzalez). There too, the hearing produced no changes to the authority of the President and the Secretary under the ESF statute.

undermine the global currency exchange system and jeopardize vital U.S. economic interests.[19]

[19] As a senior Treasury Department official in the Reagan and Bush Administrations articulated the issue.

> Globalization of the world economy and financial markets has changed the nature and scope of strains on the balance of payments adjustment process. There is more latitude for exchange rates to fluctuate, and indebtedness problems have arisen with serious implications for world financial markets. The ESF . . . is the U.S. Government's only instrument providing the means for a rapid and flexible response to international financial disruption which can impact adversely on the U.S. economy. The ESF provides a powerful and flexible means for the Secretary of the Treasury, with the approval of the President, to support our obligations in the IMF, especially those concerning orderly exchange arrangements and a stable system of exchange rates.

Review of Treasury Department's Conduct of International Financial Policy: Hearing Before the House Comm. on Banking, Finance and Urban Affairs, 101st Cong., 2d. Sess. 4 (1990) (statement of David C. Mulford, Under Secretary for International Affairs).

THE MEXICAN PESO CRISIS

WEDNESDAY, MAY 24, 1995

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:01 a.m., in room SD–538 of the Dirksen Senate Office Building, Senator Alfonse M. D'Amato (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN ALFONSE M. D'AMATO

The CHAIRMAN. The hearing will come to order. Good morning. I welcome our two panels of distinguished witnesses.

Over the last few weeks, the Administration and the Mexican government have been painting the picture of a Mexico on the road to recovery, but recent reports present a more disturbing picture.

At today's hearing, we will examine the true impact of the Administration's aid package on the Mexican banking system and economy. I urge my colleagues to watch Mexico over the next few months. It's important, and let me tell you why.

To date, the Administration—that is, the American taxpayers—have sent $10 billion from the Exchange Stabilization Fund to Mexico. Two billion dollars was just sent last week. The Administration has said that it would send the second $10 billion, which becomes available July 1, 1995, only in an emergency.

I am very concerned. I am concerned that when we started our rescue mission, we first said no money would have to be spent. Then we altered that and said we would not spend more than $10 billion. Now we're saying, only in the case of an emergency would we actually begin to draw down on the balance.

Mexico will face a very real crunch in July and August because a $6.2 billion Tesobono will come due then. The largest wave of layoffs ever will occur, severance payments will expire for many workers already laid off, and the Mexican banks and state governments will need more money to stay out of bankruptcy.

The Administration and the Mexican government have claimed that the bailout is a success. I believe there are reasons and facts that would reasonably dispute this.

While the Mexican stock market and the peso have improved, the rest of the economy is in shambles. Hundreds of thousands of Mexicans have lost their jobs.

The Mexican banking system is in trouble. With interest rates of 100 percent, over $10 billion of bad loans, and raging inflation, the system is being devastated.

I was stunned recently when I looked at the first quarter earnings reports by some of the Mexican banks. According to an analysis by the Federal Reserve, every one of the top six banks in Mexico lost money. But these same banks that our Federal Reserve said lost money reported profits in the first quarter by using rather creative accounting methods and government subsidies.

The financial alchemy is hiding a massive hole in the Mexican banking system. I've heard estimates as high as $25 to $50 billion.

I'm concerned about the U.S. taxpayers' dollars being used to bail out failing Mexican banks. The Mexican government has already intervened in three banks. Many more are getting government subsidies.

Where is the money coming from? Does the Mexican government have the system in place, the discipline and the resources to handle this problem when it gets worse?

If not, are they going to look to the U.S. taxpayers to bail out these institutions?

The Administration's aid package has not helped the Mexican families or small businesses. The Administration committed $20 billion of U.S. taxpayers' dollars, but the vast majority of the Mexican people will not get any help. The Mexican people are being punished while the wealthy global speculators are being rewarded with huge profits.

If the Administration and the Mexican government wanted to help the Mexican people rebuild their country, they would have placed restrictions on the Tesobono holders. They would have required the people who benefited from their short-term speculation in Mexico to reinvest their profits in that country. The Administration and the Mexican government would have developed a long-term strategy to rebuild the Mexican economy or help the Mexican people.

Instead, the Mexican government, aided by our Administration, had perpetuated a vicious cycle, pouring money into Mexico and draining it right back out, and the Mexican people are left with a huge debt to repay.

Our first panel, an impressive group of Mexican politicians, business people, and academics, will provide a Mexican perspective on whether the Administration's bailout plan is working.

Our second panel, a group of financial experts, will assess the impact of the Administration's aid package on the Mexican economy and banking system.

This hearing is an opportunity to educate the American people and Congress and let the public know what is really happening in Mexico and how their tax dollars are being spent.

Senator Faircloth.

OPENING STATEMENT OF SENATOR LAUCH FAIRCLOTH

Senator FAIRCLOTH. Thank you, Mr. Chairman. Thank you for holding this hearing. I think it's absolutely important and necessary that we have it.

Mr. Chairman, the hearing today is going to focus on the Mexican banking system. I was disturbed just the other day to learn that Mexico has now already used $10 billion from the Exchange Stabilization Fund.

While Mexico supposedly is enjoying some kind of a little temporary economic rebound, I fully believe it's a total facade and that there isn't any rebound. I think the fundamentals in the Mexican economy are extremely weak, and I think this hearing is going to demonstrate that.

In the past year, past-due loans have doubled in Mexico's banks. Over half the credit cards in Mexico are in default. We are told that Mexico's banks are thinly capitalized, and I think that's the understatement of the year, and if proper accounting principles were followed, that all Mexican banks would have recorded a loss.

Mr. Chairman, we don't have $10 billion to give to Mexico. We're going into debt at some $840 million a day ourselves. If we don't get our own financial house in order, there won't be anybody to bail us out.

It was said that the Administration and President Clinton would only use the second $10 billion in an emergency. Now, this money becomes available July 1, 1995. Mr. Chairman, the emergency will be at 8 a.m., July 2, 1995, and that's when it will go. I promise you.

Moreover, I note that we need as much as $14 billion for the Savings Association Insurance Fund to pay off past debts and provide the funds with adequate reserves in this country.

Why are we giving money to Mexico when we need to restore safety and soundness to our own insurance funds?

I strongly opposed the first $5 billion to Mexico. I didn't know they had the second $5 billion to make $10 billion. And when the second $10 billion goes to make $20 billion, we can write it off as a gift and money we will never see again. I was opposed to it then and I am opposed to it now.

I thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

We'll proceed with our first panel. Our first panelist is Javier Livas, who finished second in the last Presidential primary for the PAN candidate. He's a businessman and leading analyst of the Mexican political system.

Mr. Livas.

OPENING STATEMENT OF JAVIER LIVAS, PAN MEMBER, FINISHED SECOND IN LAST PRESIDENTIAL PRIMARY FOR PAN CANDIDATE, BUSINESSMAN AND ANALYST OF POLITICAL SYSTEM, MEXICO CITY, MEXICO

Mr. LIVAS. Thank you, Mr. Chairman. I want to talk about the post-devaluation Mexican economy. I want to sum up my statement by saying that, according to the latest financial figures, the Mexican economy is beginning to stabilize and recover from the devaluation shock. The real economy, however, is just entering its worst crisis in decades. This is a fact that we should be willing to face.

The Mexican government has always been very good at manipulating economic figures. We have had a taste of this on many occasions. All of last year we were told that we were doing fine, and that Mexico was on the verge of becoming a First World country. We know what happened last December 20, 1994.

So now, with the help of a $50-billion-plus rescue package, the financial figures have started to make significant improvements. But it's only because they were so crazy in the first few weeks.

The government is now saying that the peso/dollar exchange rate is changing, and that's correct. We have the peso at the level of 5.9 to the dollar. It has appreciated approximately 22 percent from its lowest figure in March, which was at 7.6 to the dollar.

The interest rates have fallen about 25 percent in the last 2 months. The CETES, which are the Mexican treasury bills, have gone down to about 58 percent instead of 83 percent at their highest level.

The Tesobonos, the privileged Tesobonos, have been reduced from an original $27 billion to $12.5 billion, which is a 60 percent reduction.

Exports have experienced a fantastic increase and the deficit is down substantially.

Anybody investing in the Mexican stock market in March would have made a 38 percent, perhaps 40 percent, profit in these 2 months.

The Mexican government is having a budget surplus because they also manipulate some of those figures.

The Mexican reserves have grown about $2 billion, up from $6.2 billion to about $8.3 billion this last May 12, 1995.

Now, all these figures are shown with pride by the Mexican government, but what is not considered is the excruciating pain of the real economy, what it's going through. It is lagging far behind the optimistic figures.

Mexico is in the midst of a full-fledged recession. Economic activity, measured as the gross domestic product, is expected to decrease by 4 percent this year. So, after 10 years of little growth, 2 percent yearly economic growth in a very underdeveloped nation, it is the Mexican people that are paying a dear price for this stabilization program.

The unemployment figure is impressive.

Interest rates paid in banks for loans are always, right now still, close to 100 percent a year. They are creating the bankruptcy of tens of thousands of small- and medium-sized businesses, and this is also creating a lot of unemployment. This is the way we see the economy shrinking.

Unpayable loans, as you mentioned, are perhaps one of the best indicators. Debtors are not able to pay their obligations to the bank. Nobody is paying the banks. Banks are not paying themselves, either. There is no money.

Small- and medium-sized businesses are the hardest hit part of the economy. They are laying off people. You mentioned that the severance payments are running out because, in Mexico, you pay 3 months and 20 days for each year of employment and that's it. There's no insurance.

We also see that inflation has increased, in just these 4 months, 23 percent, while wages have increased nominally 10 or 12 percent.

I am concerned, in light of the above, that the effort to bring back investment from Wall Street or from abroad will not have the time needed and may easily end up in unprecedented social unrest. The economic medicine set up by the two Administrations, the Zedillo Administration and the Clinton Administration, might just well end up killing the patient. This is the worst outcome possible. There is a dangerous feeling of helplessness invading our country

and our people. The following circumstances are behind that feeling of helplessness.

People do not trust the Zedillo government. As you know, the PRI was reelected last August. We are facing 6 more years of a country that is grossly mismanaged by the same people that took us into the crisis.

There's no credibility of the government. We think that the Mexican political system is beyond reform. It's beyond repair. It is too corrupt to heal itself, and this is the government that is being backed by your money, by the money of the American people.

The bailout package has not helped the real economy. It has helped to pay the Tesobonos. It will be used completely. You can have a complete assurance that every single penny this Administration has compromised is going to be used, and it's probably not going to ever be repaid. There is no capacity to repay because the money is not coming into Mexico in the first place.

Many Mexicans see the help of the taxpayers' money to Mexico with suspicion, so you're not getting any political outcome out of this in the face of the Mexican people. Mexicans feel the United States just wants to help itself to Mexican oil.

The recovery signs of the macroeconomic figures are far removed from the everyday experience of Mexicans that are having trouble making ends meet.

Let me conclude by saying that the number one priority of the Mexican economy is growth, and we are not growing. We are shrinking. We could have a terrible social and political economic crisis in the future. It's not just the money crisis, the financial crisis. It's going to be a very deep economic political crisis.

It is therefore very unlikely, very, very unlikely, that the loans will ever be repaid. You are saying goodbye to your money, if that's what you want to know, because there is no way that the Mexicans are going to be able to repay because we're not getting the money.

The money is flowing out of Mexico. The minute it touches Mexico, it's out of the country.

The CHAIRMAN. What you're saying, Mr. Livas, is that the people who come in and reclaim their Tesobonos and get paid are taking that money right out of the country and not investing it, and that they are not really the Mexican people.

Mr. LIVAS. A very small part is staying in Mexico. Perhaps the government is using that money to pump a little money into the banks.

But we had the re-privatization of the banks. Everybody remembers that. Now the banks are falling back into Mexican government hands through the bailout that the Mexican government has to do of the banks. They have to secure those loans with stock of the banks, and the government of Mexico might end up owning the banks again because there is no money.

I want just to conclude that I think it is important, and perhaps you and your Committee are a few of the people in America that are looking at the real problem, the problem that's behind everything. The real problem is not being addressed.

It certainly is not going to be addressed by the Mexican Congress that has just been reelected with President Zedillo. It's a corrupt political system. It's 66 years in power. We have to go through all

of that because this is really what underlies the problem. It's a very inefficient government. It's a very corrupt government. It doesn't matter if you pump in another $20 billion. It won't go to the right hands. It won't fall into where it could really help the Mexican economy.

The CHAIRMAN. We have a problem. The problem is that we have just started the first of six rollcall votes back to back.

I know Senator Faircloth wants to ask you a question before we're going to have to leave to go vote, and then we'll reconvene.

Mr. LIVAS. Yes.

The CHAIRMAN. We probably will not be able to take testimony for at least an hour, approximately an hour. So we will recess.

Mr. LIVAS. Yes. I am finished with my presentation. I can answer your question.

The CHAIRMAN. Senator.

Senator FAIRCLOTH. Yes, Mr. Livas. I have one question.

I said before you started speaking that I thought the $10 billion was gone and the other $10 billion would go right behind it.

When do you think the emergency will occur? The money will be available July 1, 1995. I said 8 a.m., July 2, 1995.

Mr. LIVAS. Senator, the emergency in Mexico is 10 years old.

Senator FAIRCLOTH. It's a continuing emergency.

Mr. LIVAS. Yes. We've been in a continuous state of emergency since the last crisis, the 1982 crisis. The structural situation has not changed at all.

We had a fairly decent situation when billions were pumped into the Mexican bolsa. Even then, when hundreds of billions were in Mexico, even then, the small- and medium-sized businesses were going bankrupt.

If we get trickle-down economics again, it's not going to work.

Senator FAIRCLOTH. Let me ask a question.

Mr. LIVAS. So the emergency is today. It's right now. You don't have to wait until July. We know it's going to happen.

The money is going to be needed because the investment is not rushing back.

Senator FAIRCLOTH. A question. Just suppose we were foolish enough to appropriate $100 billion and make it available in August.

Would it last until Christmas?

Mr. LIVAS. If you are willing to write it off, maybe we could start solving Mexico's problem. We have a very costly government——

Senator FAIRCLOTH. If we would write off $100 billion, would it last until Christmas?

Mr. LIVAS. Maybe. As I say, we are in a terrible emergency, and I think the Mexican government has taken the American Government for a ride.

The CHAIRMAN. Mr. Livas, the one thing we get from you is that the money being made available is bailing out the speculators and the people who bought the Eurobonds and the Tesobonos, but is not helping the business community, the small businessman, or the Mexican citizen. It is not creating jobs and job opportunities for them.

If anything, the repayment and the conditions are making the living standards worse for the Mexican people.

Mr. LIVAS. That is correct, and that is why I think the Mexican economy will not be able to repay those loans. We're not making money. We're not establishing new production facilities. We're decapitalizing the country.

The CHAIRMAN. There's a greater default rate on home mortgages than ever before in the past 10 years.

Isn't that correct?

Mr. LIVAS. That is correct because the loans—you should know that loans in Mexico are all variable interest loans, whether you're borrowing for your credit card, your home, your car, or whatever.

It's all variable, so there's a temptation for the government that manipulates the whole economy—it's a very centralized, very statist economy, in that sense, in spite of all that's being said about the opening of the borders and all of that—to manipulate interest rates and make the poor people pay.

So the medium-income families are sharing the biggest part of the burden, and we are decapitalizing families at an enormous rate, very fast. Suicides are increasing. The nervous breakdowns are increasing. The figures are embarrassing.

The CHAIRMAN. Let me ask you one final question before we go down to vote.

What is the reaction of the Mexican people toward the U.S. Government's aid package?

Mr. LIVAS. As I said, we see that with suspicion because we think you are going for our oil, and we are not getting the help we really need. It's not doing you any good as far as how the United States stands in the eyes of the ordinary Mexican.

The CHAIRMAN. We're going to take a recess. We have these six votes. We'll continue, hopefully, within 45 minutes to an hour.

We stand in recess.

[Recess.]

The CHAIRMAN. Let me apologize for the interruption, but we did have six votes.

We're going to proceed to our next witness, Gabriel Hinojosa. Mr. Hinojosa is a small businessman. He's the leader of the Foro de Cambio, an association of small businessmen.

OPENING STATEMENT OF GABRIEL HINOJOSA SMALL BUSINESSMAN, LEADER OF "FORO DE CAMBIO," PUEBLA, MEXICO

Mr. HINOJOSA. Thank you, Mr. D'Amato. First, I would like to express our appreciation for the interest you have shown regarding our opinion about our problems and possible solutions. I hope that by accepting your invitation, we may help you to get closer to the truth.

I will refer mainly to the problems of small businesses in Mexico.

I'll start by saying I'm convinced that any workable solution to the problems of the Mexican society should above all create the proper conditions for small, productive organizations to survive, multiply, and grow. This will only be achieved with a government that is committed to this fact.

I will divide my presentation into three short sections. The first one will be why the small businesses are right for Mexico.

I want to help you understand this because the Mexican economy is small.

First of all, they create many more jobs with less capital. We need many jobs and we do not have capital. So everybody should be working in small businesses.

They do not require highly-skilled people, and we do not have too many of them. They do not require excessive foreign machinery helping our trade balance. They produce quantities appropriate for the small domestic market. They take advantage of the existing assets, both humans and materials, and they account for more than 80 percent of all the jobs, both in the formal and informal economies.

Small businesses in Mexico are really disappearing. By doing this, they are putting the Mexican society in a very terrible situation.

Why are they disappearing?

They are disappearing because the model followed in Mexico for several years has not promoted the development of small business units. On the contrary, it has given preference to big corporations and hindered the growth of small ones.

This is not the problem of last December. This has been for years and years and years, that the productive entities have been neglected, excepting for the big corporations that have the power of lobbying and making the government design things for them.

Small businesses are disappearing because they do not have any other options but to go along with the Mexican banking system, which behaves like a cartel, avoiding real competition and charging society too much.

They are disappearing because they do not have the infrastructure that they need and whatever is there is operated by the government and some big corporations that charge at will for their services.

This is the case of the telephone company, toll road system, gasoline, and electricity.

We are disappearing because our inefficient government demands more and more resources every time. They create all kinds of new taxes, ignoring the important social role of small business, and by taxing them too much, they are destroying them.

They are disappearing because there is governmental corruption, and there is all kinds of very harsh punishment to those who fail to comply with a system that is impossible to comply with.

That takes a very high toll on small business.

The cost of money is very high. To our knowledge, there are three reasons for that.

The first one is that the Mexican government is borrowing its money from the international society and has to pay very high interest rates compared to the international normal interest rates.

In other words, the Mexican government is using very expensive loans. We have to add that the Mexican banking system is charging a lot. They do not have competition and they agree with each other—at least this was what was done in the past. They charge whatever they do. I think some of the other people on this panel will explain that better to you.

The third factor is that we have inflation. That puts all the small business infrastructure in a nonfeasible position. We cannot work in that environment.

The market has collapsed as a result of all the recessive plans that pretend to stabilize the economic indicators without taking into consideration the Mexican people and the future of the country.

We do suggest the third part of my interpretation, which will be solutions and corrections.

No economic plan will work if we do not recover the confidence in our government, which has never been very high and is now at an historic low.

We need to implement an emergency program that eliminates all unnecessary barriers and liberates all possible productive forces.

That stimulates investment, both national and foreign.

We need to renegotiate the national debt for a longer period and have a fair interest rate.

We also need to invest as much as possible in infrastructure and education, open the banking system to all international competition so that we have banking helping small business to work projects and everything that is productive, and make sure all the international finance and help goes through as few internal layers as possible to reach the productive sector, especially the small business area.

In conclusion, unless Mexico can recover and grow by allowing foreign aid to reach the productive sectors, serious problems and social unrest will occur. There will be no possibility to pay back loans and no wealth will be created.

Mexican entrepreneurs with social consciences are ready to do their part and pay their debts, as soon as proper conditions are met.

I'd like to add that Mexico is going to need a lot of help, but we need to make sure that help gets to the productive sector and to the heart of the problem, not the way it's been going because we haven't gotten a drop of rain of this whole program.

The CHAIRMAN. So you're saying that the aid we have been sending to Mexico has not been reaching the small business community.

Mr. HINOJOSA. Yes, that's correct. I think the whole productive chain has been broken. I would like to add that 10 days ago, and I have some pictures from the local papers here, there were riots in Puebla, as evidence of what is happening over there. More than 30 people went to the hospital and the police were using gases and dogs to control these people who were trying to earn their money on the sidewalk by selling something. So we are in a crisis and the violence is there.

The CHAIRMAN. Let me ask you, since the infusion of money, has the situation gotten better or worse as it relates to the small business community?

Have interest rates gone up or down?

Mr. HINOJOSA. The interest rates have gone up and down, but the small business community is not paying anything because we cannot pay. We cannot pay our vendors, our providers, nor can we pay for the raw materials.

So the actuality is, no fresh money has gone into the business sector and the fact that we owe a lot of money and the interest rates are going up and down is almost meaningless because we do not have money to pay.

The CHAIRMAN. OK. Our next panelist is Liliana Flores, a member of the Mexican Congress from 1991 through 1994.

Ms. Flores.

OPENING STATEMENT OF LILIANA FLORES FORMER MEMBER OF THE MEXICAN CONGRESS, NATIONAL EXECUTIVE COMMITTEE, MEMBER OF "EL BARZON," MONTERREY, MEXICO

Ms. FLORES. Yes, thank you. I'm here representing El Barzon. El Barzon is a national organization that was born in Mexico 2 years ago. It agglutinates Mexicans of the small and medium productive sectors of the country which are the expression of the Mexican middle class. It is an organization that was basically founded by farmers and cattlemen but, today, is also formed by businessmen, traders, service lenders, college-educated people, and employees, all united with these problems—past-due credit, lack of liquidity and profitability of their productive units, and decapitalization. Politically and ideologically, it is a plural and democratic organization and it is here to break the traditional organizational schemes in Mexico. At present, there are more than 1 million affiliates.

Those who claim that the Mexican crisis started with the devaluation of December 1994 are totally wrong. The instrumentation of the neoliberal model in Mexico since 1982 accumulated a great social cost that was translated into a social debt that different sectors of the Mexican population are demanding must be paid. The demand gets even greater after a great ideological fraud that Salinas de Gortari made to the nation and to foreign countries, making them believe that my country was the vivid expression of the success of this neoliberal model, up to the point where we were changing from a Third World country into a First World one. This was a great lie for everybody.

While all the Mexicans were soaking in a speech that told us about a fiction economy, the reality of millions of citizens was different. The decay in the quality of life was tremendous. The crisis that is produced after the peso devaluation was existent in the Mexican rural area 2 years ago.

After the devaluation in December 1994, the problem of the past-due credit became more serious. The irrational increase of the variable interest rates, up to 130 percent annually, and the application of the shock program have made this economic problem to turn out as a national social problem. The terrible decay in the quality of life has caused a great weakness in the Mexican family. The uncertainty of losing, or not being able to pay for the family patrimony, has caused a great number of suicides—we have counted 451—an increase in heart and nerve diseases, divorces, and problems with the children.

What else could we expect if in 1994 there were 18,000 properties adjudged in the rural areas, or now in 1995 more families have lost their houses to the banks than those who lost theirs during the 1985 earthquake?

The fact that for an executive decision the Clinton Administration authorized a bailout for $20 billion so that passives are to be paid in a short-term is a great mistake, like it was managed. It is exactly the same logic of the owners of money in Mexico—"I'll lend you so you can pay me, but I need guarantees." In this case, the guarantees were the future sales of the oil. In the economic and social context, it would have been very important to renegotiate at a medium- and long-term some part of the short-term debt, and a part of that bailout line of credit would enter as fresh money to the economic flow of the country, since there is no money to work.

The only way to guarantee this money is going to be repaid is to make this the plan.

Somebody might ask, "Why does the United States have to help Mexico in such a way?"

Simply because the demands that the International Monetary Fund and you make to the Mexican government can also hit the American country as a boomerang. As an example, it's enough to say that the NAFTA is a dead letter. Let's remember the main argument of those who defended it. They said that if it was approved, the door to the largest potential market of Latin America would be opened. The issue is that the potential market, the Mexican medium class, can't buy anything since we are at present at subsistence levels and, while we don't have any money to work, we will continue in the same situation. This automatically will translate in a loss of jobs for the North American people. Also, we mustn't forget that we are a sector that supplies more jobs in the country, and that if we are affected economically, the ghost of the lack of jobs will be in the streets of my country. You that have made the migration problem an issue of political debate, inclusively for the next Presidential elections, regardless of the walls, police, and fees you charge, you will still have millions of economic refugees in the border with Mexico. This problem will be prevented by generating jobs in the Mexican cities and preserving the existing jobs.

That's why we need fresh money in the Mexican economic flow.

A recessive shock plan, an usurious financial policy, the drought that is affecting the northern states of Mexico, and the closure of spaces where we can make our opinion be heard, that is our daily life. We Mexicans saw with great impotence, as an obscene sign from the PRI leader of the Mexican Congress, the approval of the IVA tax increase. The annual amount of what will be recollected is equal to the gross income that Carlos Slim receives in 5½ operation days in his companies. Is this a fair neoliberal economic policy?

You mustn't forget that the Mexican people don't notify, they simply act. We, with our movement, have decided to fight within the limits of the law, making of the rights, a culture. We have decided to pick up our ran-over dignity and fight for our family, our patrimony, and for our country. With the law in the hand and the pacific but active civil resistance, we will continue to impulse this movement of consciousness in our dear Mexico.

The CHAIRMAN. Thank you very much, Ms. Flores. I'm sorry to hear the great distress in your voice, but I just have to raise a question, a rhetorical question.

I wish more of my colleagues were here so that they could ask you specific questions.

How can we ever hope to have these loans repaid when the money is not reaching the Mexican people? Those people, those speculators who made investments, are getting their investment back. For the most part, they're taking the money out of Mexico and, now, the repayment of those loans is expected to come from the Mexican people. The methodology somehow resorts to raising interest rates, in some cases, to 100 percent.

What I've heard from three witnesses so far, and from Mr. Hinojosa, is that no one is paying, because you can't pay interest rates of 100 percent.

So the businesses aren't paying. You've indicated that the default rates in terms of homes lost, that many thousands of homes are being lost because people can't pay their mortgages. Is that right?

Ms. FLORES. Yes.

The CHAIRMAN. So we're not helping the Mexican people, and the anger felt within the community and the frustration level must be rising continually. Is that true?

Ms. FLORES. Yes. I think that the things—my English is not very well.

The CHAIRMAN. We understand you.

Ms. FLORES. I think that—[in Spanish].

Dr. AUPING [translating]. —the situation may change.

Ms. FLORES [in Spanish].

Dr. AUPING [translating]. In order to pay these debts, first, the productive sector of the economy should be stimulated and make gains. Then they could pay.

Ms. FLORES [in Spanish].

Dr. AUPING [translating]. That is why she proposes, El Barzon proposes, that the $10 billion that is still being——

The CHAIRMAN. That has not been paid over yet.

Dr. AUPING [translating]. —that's not been paid, that it should be used not to rescue the Tesobonos, but to stimulate the productive sector of the economy.

Ms. FLORES [in Spanish].

Dr. AUPING [translating]. By that way, we would prevent economic collapse and Mexico would be a market to buy American goods.

Ms. FLORES [in Spanish].

Dr. AUPING [translating]. It would also diminish the problem of illegal immigrants.

The CHAIRMAN. I want to thank you. I agree that the rescue of the Tesobonos and the bailing out of foreign speculators has done little to improve the economic condition for the productive sectors of society, for the business community, or for the farmers and Mexican citizens.

That's what I have been gathering from information, from media accounts, and from Mexican citizens such as yourself.

Our next witness is Dr. John Auping, an economist at Ibero-American University in Mexico City.

Dr. Auping.

OPENING STATEMENT OF DR. JOHN A. AUPING, PROFESSOR OF MACROECONOMICS, IBERO-AMERICAN UNIVERSITY AND AUTONOMOUS TECHNOLOGICAL INSTITUTE OF MEXICO, MEXICO CITY, MEXICO

Dr. AUPING. Thank you, Mr. Chairman.

The CHAIRMAN. Did you bring a chart?

Dr. AUPING. No. The chart is very interesting. It's made by your staff members.

The CHAIRMAN. OK.

Dr. AUPING. But it would be interesting to see the chart, yes.

The first one, the other one. You didn't make the other chart.

The CHAIRMAN. OK. Dr. Auping, do you want to testify?

Dr. AUPING. You, in your letter, asked that we talk about the impact of the peso devaluation and the adjustment program on the banking system and the economy of Mexico.

I think it's important, first, to notice that the crisis of the Mexican banking system existed long before the December devaluation. The reason is very simple, the reason why this crisis existed.

When they nationalized the banking system in 1982, they paid little to those owners. When they re-privatized the banking system in 1991 and 1992, they charged twice the price of the value of the assets. They charged $13 billion for banks that had assets that had a value of $6½ billion. There was a silent agreement between the government and the banking system, the new owners, that is even registered in the NAFTA, that there would be no foreign competition with the Mexican financial system so that they could charge society for the expensive investment they had made.

In 1993, when inflation was only 8 percent in Mexico, the nominal interest rate on loans varied from 25 to 36 percent, which means a real interest rate on loans that varies from 16 to 26 percent. So the problem of usurious interest rates already existed before the December devaluation.

In addition to that problem, there was a problem of overvaluation of the peso and cheap imports. Many companies, big and medium companies, were brought to the actual bankruptcy before the December devaluation.

Now, what did the peso devaluation add to this problem that already existed? It made it worse. The problem was aggravated in a very substantial way, but it did not create the problem.

Right now, the differential between interest rates on savings and on loans is up to 45 percent, where, before the crisis, the maximum differential was 20 percent. Before the crisis, interest rates on savings, real interest rates on savings, were positive. Right now, the real interest rates on savings are negative, from minus 23 percent to minus 8 percent.

So we have a banking system that is not stimulating the economy to invest and to save, but is robbing them in two ways. It robs the people that save by negative real interest rates, and it robs the people that take loans by charging usurious interest rates.

In the case of credit cards, interest rates go up to 110 percent.

So there, as a consequence, comes the problem of the notes due.

In 1993, notes due in real terms increased by 60 percent. In 1994, by 80 percent. And in the last 3 months, the first quarter of 1995, in real terms, notes due increased another 30 percent.

Right now, the total problem of notes due is, on business loans, 76 billion new pesos; on mortgages, 31 billion pesos; on states' debts, 15 billion pesos; and, on dollar loans, 5.9 billion United States dollars. The total amount of notes due on April 24 was 157.4 billion new pesos.

The government has tried to ease the problem by introducing the so-called investment units that keep debts constant in real terms and make debtors pay only—between parentheses—only real interest rates, that are usurious, of course.

This solution postpones but does not prevent bankruptcy, making it even worse when it arrives. This is why companies and families with debts prefer other solutions associating themselves in organizations like El Barzon.

The majority of companies with notes due and of people whose properties are mortgaged will keep on being unable to pay what they owe. So banks won't get their money back.

At the same time, there will be a massive problem of decreasing savings, since people lose their jobs and withdraw their savings in order to consume them.

At the same time, big companies and rich families keep their savings in the United States.

I think it's important to note that more than half of Mexican savings are in other countries, equaling about the same amount of the assistance package. So banks will be short of cash, anyhow.

Given the fact that the banks obtained government bonds in exchange for the notes-due documents through the mediation of a trust fund, banks having cash-flow problems will put pressure on government to let them collect pesos for their bonds.

Should the government yield to this pressure, that would mean hyperinflation. Should it not yield, as is probable, then the banks have two options—to be bought and rescued by the Mexican government, as has already happened with Banco Cremi and Banco Union, starting a subtle process of nationalization of the banking system, or to be bought and rescued by United States banks, if they were willing to.

Now, you also mentioned the impact of the adjustment program on the Mexican economy. I think the package in itself rescued Tesobono holders, and that's it. But the conditions attached to the assistance package are very harmful to the Mexican economy.

The Administrations of the United States and Mexico agreed to this package and attached conditions, in spite of the International Monetary Fund, that decrease the real amount of money in the economy by minus 20 percent, and decreased internal demand by at least minus 10 percent.

This will provoke a recession this year of minus 5 percent of gross domestic product, together with an increase of interest rates that were already usurious before the crisis and are now even more so.

Sales in different branches of industry diminished from 30 to 100 percent.

Employment will be brought back this year to 22 million people working in the formal sector, which is the same level that existed in 1981. That means in 14 years, not one job will have been created in the formal sector.

At the same time, the labor force is increasing at 3.6 percent annually. That means right now, the rate of unemployment and underemployment in the formal sector together is 41.5 percent.

At the height of the Great Depression, your underemployment rate was 25 percent.

The Mexican government is taking the same measures that your government took in 1929 when they transformed the recession into a depression, but in a more severe way and facing a more massive unemployment problem than at that time.

Now, the economic theory behind the adjustment program is alien to reality. If people are interested in that point, they can get the study from your staff members. I will skip that point.

I would only say that Mexico has fallen four times in the same trap: in 1976, in 1982, in 1987, and 1994–1995. The interaction between inflation and devaluation in Mexico has a typical 6-year pattern. For some years, loose monetary policies create inflation rates that surpass devaluation, accumulating pressure on the pegged exchange rate. When people bet that the overvalued peso will lead to devaluation, capital flight provokes a macro-devaluation that surpasses the devaluation that would have sufficed to neutralize overvaluation of the peso. Demand of dollars will push the devaluation to the point where a severe undervaluation of the peso is established. So we pass from overvaluation to undervaluation.

In the undervaluation, you import inflation because imported goods are twice as expensive as national products and people adjust their prices. So, then, it starts the same process again. After macro-devaluation comes down to 10 percent, 15 percent, 5 percent, but inflation is 60, 80, 50 percent for some years, it will be slowly brought back by orthodox measures if they have success. But, then, new pressure is built upon the pegged exchange rate and a new macro-devaluation will take place.

This has happened four times, exactly the same pattern. Right now, the International Monetary Fund and the Zedillo government are preparing to fall for the fifth time in the same trap.

We who are present here are not experts in zoology, but we all know that animals do not fall twice in the same trap.

We fell four times in the same trap and are preparing to fall for the fifth time in the same trap.

The euphoria about the apparent stabilization of the exchange rate is the same euphoria that existed after the market devaluation of 1976, after the market devaluation of 1982, after the macro-devaluation of 1987, and now the International Monetary Fund is repeating the same euphoria.

They seem not to learn from experience.

The CHAIRMAN. Dr. Auping, I want to thank you. Again, I wish and hope that some of our Members and the Administration will get the message.

It is one thing to attempt to help a good neighbor, which we're attempting to do, and another thing to do it in a manner that actually fails to help the neighbor, that leads people to continue policies which in many respects have the opposite result and really hurt more people than would have been otherwise.

It has still not been explained to me how rescuing the Tesobono holders in the manner in which we did had anything other than

a disastrous impact as a result of the imposition of these very strident conditions on the Mexican people and on the Mexican economy.

Politically, we certainly have not gained the friendship that one would think would be there because if my interest rates went up from 30 percent or 20 percent on a home mortgage to 80 percent, I wouldn't be very happy as it related to how this has come about. That would be understandable.

So here we think, and I think the American Congress and the American people think, that we were helping our neighbors to the south, and, indeed, the practical results are that we may be bailing out some very wealthy people, but we're not helping the situation.

I have to respond that there was an early observation by Mr. Livas that the system, the political system, is beyond reform. I think we're operating under a myth, that the political system there is one which is capable of reforming itself. I don't believe that's the case.

But leave that to another day.

Mr. Artis. Mr. Artis is president of the National Association of Manufacturers.

Mr. Artis, welcome.

OPENING STATEMENT OF RAIMUNDO ARTIS, PRESIDENT, NATIONAL ASSOCIATION OF MANUFACTURERS (ANIT), BUSINESS LEADER, MEXICO CITY, MEXICO

Mr. ARTIS. Thank you. To understand the actual situation of the economy in Mexico it's necessary to clarify some points that were maintained obscures in order to have better public image for the government of Salinas, in Mexico and abroad.

The structural change of the Mexican economy never considered the evident following main causes of the recurrent monetary crises.

First, plans and programs of government oriented to the very short term. If the results or benefits will take a longer period than the life of the government, the issue is not even considered.

Second, overprotection to the financial system, such as banks, stockbrokers, etc. Overprotection to monopolies, like in copper or steel or the telephone. Overprotection to the big multinational companies, like the automotive and food companies.

Third, inequality on taxes. The taxes for the enterprise in Mexico, it's a fixed rate of 35 percent no matter how small the company is. That means that if you earn one peso, you have to pay 35 cents.

Fourth, low return on investment for most public and private projects, as political or personal profit reasons are mandatory over economical or correct business reasons.

Fifth, weakness of the monetary system, as most of all decisions are politically oriented and not technically supported.

Sixth, illegal use of public resources for personal profit and abuse of privileged information.

Seventh, excess of monetary or liquid resources on the financial system which promotes speculative movements greater than normal. That is exactly the case of the Tesobonos.

At the same time, another main problem for the productive sector during the Salinas years has been the interest rate charged by banks, which makes the bank business in Mexico one of the most

profitable in the world. Along with the extraordinary overcharge, primary rate was always ranked high enough to attract speculative foreign capital. So from the point of view of industrial enterprises, interest rate is an unbeatable handicap for competition.

The lowest rate those years was 28 to 30 percent, and most of the time was higher than 38 percent, with inflation close to 7.5 percent.

Taxpayers paid generously for the whole banking system, after the expropriation in 1982 of original owners, in less than 10 years. Users of the banking system paid the extremely high price that the new owners paid for those banks in less than 5 years through the profits.

Again, taxpayers in Mexico are giving to the Secretary of Hacienda quantities to the banks equivalents to their prices in most cases, to prevent them from bankruptcy.

So the country paid the complete value of the banking system three times in less than 12 years. You helped a lot.

After devaluation in December, banks increased interest rates to more than 110 percent, making unpayables most of the credits.

In the last 6 months, no new credits are authorized by banks. All credits are restructurations, so productive activity is at a minimum, and more than 800,000 workers lost their jobs in the last 3 months.

Last year, manufacturing companies closed operations and, as indicated, employment today is smaller than 10 years ago in this sector. Since December, this phenomenon has accelerated and, as the time passes, it's more difficult to restart operations and market each day is smaller.

It is evident for practically every trade association that there is imperative today a change in the policy which promotes immediately growth, as otherwise social explosions of unpredictable consequences may happen in a very short time.

The government of Mr. Zedillo up to now seems to be following the wrong path followed by Mr. Salinas to give priority to inflation, rate of exchange, and financial equilibrium on government expenses over employment, growth, and other variables reflecting the level of living of the population. Those indexes reflect the continuous lowering over 10 years in the standard of living of the majority of the people.

Equilibrium on government expenses is a priority, but the main problem is having nearly 4 million bureaucrats. That is about one for each seven workers. That is what has to be reduced, not the basic investment. It is not sacrificing the investment to pay people and also to pay the extremely high interest of the debt.

To finish, I don't say a word about the big loan made available by President Clinton, the International Monetary Fund, and others. There is a reason. That money is only used to change short-term credits, Tesobonos, to long-term, and, to some extent, to support losses in banks, but not a dollar is to promote growth, which we feel is the unique way to pay.

Thank you.

The CHAIRMAN. Thank you very much, Mr. Artis.

I'm going to ask my colleague, who I really appreciate being here, Senator Faircloth, if he has some questions for the panel?

Senator FAIRCLOTH. I do, for Mr. Artis.

I'm not asking specifically for names, but who owned these Tesobonos? Were they foreign-owned? Were they owned by wealthy Mexicans? Generally, who owned them?

Mr. ARTIS. They're owned by both. The main question is that Tesobonos were stated as denominated in dollars, to be paid in dollar terms, but the owners of the Tesobonos are mostly foreign, but some are local.

Senator FAIRCLOTH. The interest rates on them, the lowest were about 28 percent.

Mr. ARTIS. That's right.

Senator FAIRCLOTH. So we're bailing out investors who were drawing 28 percent or higher interest on these Tesobonos.

Mr. ARTIS. That's right, also. It's nominal because if you include the devaluation and the times of capitalization, the interest rate can be a lot higher for the owners of the Tesobonos. That's clear.

The CHAIRMAN. In other words, if the peso dropped in value and they're redeemed in dollars, then the rate of return is much greater for people who invested in Tesobonos.

Mr. ARTIS. That's right.

Senator FAIRCLOTH. I'd like to ask each of you the same question.

Do you think there's any chance the American taxpayers are going to be paid back this money?

Mr. Artis?

Mr. ARTIS. Not really.

Dr. AUPING. If the adjustment problem is radically changed and new measures are taken, yes. If not, no.

Senator FAIRCLOTH. If what?

Dr. AUPING. If the agreement signed by Mr. Rubin, Mr. Ortiz, and Mr. Montserrat, is renegotiated and new conditions are attached that will not provoke a depression, and certain new measures are taken into account that mention my study, I think Mexico would be able to pay back what it owes.

If they go along the road they are following now, they will not be able to pay that back.

Right now, the external debt of Mexico is $180 billion. The whole economy is in the state of implosion. Of course, we'll never be able to pay that back.

Senator FAIRCLOTH. Yes, sir?

Mr. HINOJOSA. I would say that we Mexicans, El Barzon, and all the business people I know are very responsible for what we get, and we do like to pay.

I would think in the future—we cannot pay now and this will have to be renegotiated to sometime in the future. Then a boomerang will come back to this, and this is a moral boomerang, because we Mexicans are going to check very closely on what the money was used for because, whatever money they give to the Mexican people, we are going to pay back. The rest of the money we are going to have to think about, and we are going to bring that to the negotiation table.

Senator FAIRCLOTH. What you're saying now is that the Mexican people have received none of it, so——

Mr. HINOJOSA. If any money was misled or misplaced, we won't pay.

Senator FAIRCLOTH. What percentage, in your opinion, has been misplaced?

Mr. HINOJOSA. I don't have the information on that and, in Mexico, remember the information is always crooked. The future will let us know.

Senator FAIRCLOTH. But you're implying that most of it has been misplaced, that the Mexican people have received very little.

Mr. HINOJOSA. Yes. It has been misplaced by the Mexican people. I buy the interest of the international capital. Let's call it investors. They are playing a gambling game in Mexico, and they are thinking that the Mexican society is going to pay for it, and I don't think that's fair.

That boomerang will come back. We will find out in the future. I don't have the facts now, but we'll find out.

Senator FAIRCLOTH. Mr. Chairman, we might be the only Nation in the world that continues to make a loan when the country says they're going to default on it before we get it made.

The CHAIRMAN. I think that's true. I think more shocking is that there are people in this Administration who know that the likelihood of these loans being repaid is minimal, and certainly not without vast restructuring, as Mr. Hinojosa has indicated.

I would like to ask, Mr. Livas, how do the Mexican people feel? Have they lost faith in their government? Is there a likelihood of political and social upheaval?

I've seen some articles that have indicated that in some cases, hundreds of thousands of people have come together to protest the increases in the interest rates, the cost of living, and the massive unemployment.

Is that correct?

Mr. LIVAS. One of the reasons why Mexicans feel helpless is because they know that our government has a way of getting the backing of the U.S. Government. People don't like to go against the U.S. Government in a straightforward manner.

So what's going to happen?

As the crisis gets worse, people will be forced by circumstances to do something that perhaps they have never tried.

With El Barzon as an example, El Barzon will oppose the orders of judges to take over property, and they do it as a de facto thing because this is the only way that people can keep their houses.

We're going to see more of that, and maybe we'll see unrest. We don't know what's going to happen.

What we do know is, if you look at the historical record of the debt of Mexico, we've never owed a lesser amount than we did the day before. If the monies are not used wisely, what little money there is, then there's no chance that we can repay. It's as simple as that.

Our government has centralized all the finances of the country and made bad business outside. Now it's asking the country to repay the mistakes.

This is not just the Tesobonos. Tesobonos were converted CETES obligations that were making a very big interest rate. When investors started panicking, they changed the denomination of the CETES, which were peso-denominated, into dollar-denominated.

This means that there are people who have taken enormous profits from the system and the whole assumption is that, with the money of the U.S. Government, investors will come back in great numbers and reestablish some sort of balance as it was perhaps 6, 8, or 10 months ago. We think that is not going to happen because the sacrifices of the people don't make it a very good bet, unfortunately.

The CHAIRMAN. I'm wondering if there are any other observations that our panelists would like to make before we move on to our second panel?

Mr. LIVAS. Just one. I should have said at the beginning that, although I am a member of the PAN party, I do not come here to speak as a member of the PAN. I just come here as an ordinary citizen who is concerned with what's going on.

I think that the relationship of these two countries has to be based on truthful accounts of what is going on, not imagined or supposed figures cooked up by the World Bank and the International Monetary Fund.

The CHAIRMAN. Mr. Livas, that is probably the most cogent, eloquent statement and observation that anyone has made. It really is about time we begin to look at the situation in the eyes of reality, as opposed to the myths and stories that come out indicating that the economy is improving, that the situation is much better, that it's a rosy picture, and that things are getting better.

If you look at some figures that are manipulated to show that businesses are making money, or appear to be making money, but they're really not, you can paint this kind of picture.

If you point to just the foreign reserves going up, that gives a very distorted, incomplete picture, and you have just said it very aptly.

Senator Faircloth.

Senator FAIRCLOTH. One quick question, Mr. Livas.

What benefit is going to accrue to the Mexican people if we extend the other $10 billion that is committed?

What benefits will accrue?

Mr. LIVAS. The benefits that the Mexican government is assuming will happen is that Mexico as a country will recover its good standing as a creditor and that they will get billions of private investment coming back to Mexico.

It is all a big bet that this is going to happen.

Senator FAIRCLOTH. It's all based on the fact that they think the United States will continue to supply money to cover bonds.

Mr. LIVAS. Yes, it's all based on that assumption.

Senator FAIRCLOTH. That if you get low enough again, we'll come again.

Mr. LIVAS. Yes. That if we're good at repaying the debt with your money, then you'll send us more money.

Senator FAIRCLOTH. Thank you.

The CHAIRMAN. Dr. Auping.

Dr. AUPING. Yes. I think, as I see from here, your point of view is that you oppose this loan guarantee. I think the opposition will be much stronger if an alternative could be offered, and I think there exists an alternative.

As I said, the 10 percent of rich companies and rich families have their savings in Switzerland and, especially, in the United States.

If a provision could be made that, in the Mexican economy, dollars could be used, dollar deposits in Mexican banks and United States banks in Mexico, and loans could be made in dollars, all that money, Mexican money that is outside the country, Mexican savings—we need savings to finance investment, but our savings are outside the country because they do not trust the way our government manages the peso.

If we could open up our economy to the use of the dollar, then, all that money, with a slight interest of real interest rates with the United States and Mexico, would come back to Mexico, with constitutional guarantees that it will not be confiscated again as happened in 1982. Then we would not need this additional $10 billion because there's much more Mexican money outside the country that would come back if dollars could be used in Mexico.

The CHAIRMAN. Mr. Hinojosa, do you have an observation?

Mr. HINOJOSA. Yes. I'd like to finish by saying that some of us in Mexico look at the situation that is going on as a very hostile takeover of the country. They are forcing the country to go very poor. Then, probably, the big worry becomes capital. I don't think this is the American people that are doing this. I won't blame them, but I think the capital is going too, with somebody trying to buy all the good Mexican properties and things like that.

Without consideration, moral or human consideration, it seems like somebody is taking us to our debt end before somebody is going to do something. But, by that time, many people will be dead.

I think you have to believe that no system works without confidence. In Mexico, we are working on changing the system because that's the first step we need to take. Then, we will regain confidence and what Dr. Auping talked about will happen.

After that, if you want to help, I would suggest—and I think we do need the help of the international society because things have gone too far in Mexico. If you want to help, I think you have to make sure the help gets to the right channels and stop pretending because, legally, you have all the papers that show we own money. But, morally, we should remember the future, what is going to happen in the future, because we are going to come back to this subject.

The CHAIRMAN. I got your message before. Your message was clear. You said that you will repay those people who have made monies available that you receive. But, on the moral side, if you didn't receive the money, meaning the Mexican people, you do not feel that the future is one where you would want to repay those monies.

We understand that, and I wish there were some more of my colleagues here to get that message.

I want to thank the panel. I want to thank you for taking your time to be here and for sharing with us your thoughts.

I think you are representative of the silent or the forgotten voices of the Mexican people. We have been hearing from those who represent the government and government interests, but we have not been hearing from those who really represent the working people, the farmers, the small business people, and the citizens of Mexico.

You have done your country a great service and we thank you for coming.

Mr. LIVAS. Thank you very much. I think everything that we have said here can be verified by anyone taking the trouble of going to Mexico.

The CHAIRMAN. Mr. Livas, I think that, in the foreseeable future, not only will it be verified, but we will probably see the kinds of situations, with increased foreclosures and business failures, that are destined to bring about some desperate action from people.

I see that the farmers, for the first time, are joining with many of the movements in protest, and these are men who have owned their farms, which have been in the family for decades and decades, and who are proud. When they begin to see a situation which they cannot meet and which they want to, in terms of their financial obligations, but those obligations have become so horrendous that it is impossible for them to be met, and when they see their property and their way of life being destroyed, why, obviously, that is not good.

The most reasonable of people then turn to desperate actions.

Now, there will be some who will characterize my statement, unfortunately, as being—I've heard populist. I think it's realistic. I can't understand how any group of people could really think, by raising interest rates to the extent that they're being raised, by doing what we are to the credit system, by imposing the kinds of taxes that they're bragging about, a 50 percent increase in taxes, that the people and the economy are going to respond positively.

The economy is not going to respond in a positive manner. It is beating down to the ground the last vestiges of hope, humanity, and strength that you have.

Mr. LIVAS. That's right.

The CHAIRMAN. I just see a horrible situation. My colleague from New York, the senior Senator, has characterized the government of Mexico in very harsh terms. I've got to be careful of the way and the manner in which I say things because I'm not generally politically correct. I get a lot of heat for that. Some deservedly so.

But I think he's right. There is a myth with respect to so-called democracy that exists in Mexico. We have bought into that myth and we have sold that myth, being the Government, and I think that's unfortunate.

We are deceiving ourselves and we deceive lots of other people. We betray that which we're supposed to be doing and standing up for. Here, we think that we're attempting to help the Mexican people. Yes, we say the economy, but with the intent to help the people. We find it's quite the contrary.

It's very, very distressing, but we're not going to roll over and keep quiet. I assure you of that.

Thank you so very much.

Mr. LIVAS. Thank you.

The CHAIRMAN. I'm going to ask our next panel to come in. We're going to thank them for staying and waiting for us.

Jerome Levinson, of the American University, is a professor, research associate of the Economic Policy Institute, and former general counsel for the Inter-American Development Bank; Alberto Sanchez, who is the vice president and senior analyst at Deutsche

Bank; Dr. Bernard Weinstein, director of the Center for Economic Development at North Texas University; and Christopher Whalen, chief financial officer of Legal Research International and editor of the Mexico Report.

Mr. Levinson.

OPENING STATEMENT OF JEROME I. LEVINSON, ESQ. PROFESSOR, AMERICAN UNIVERSITY, RESEARCH ASSOCIATE, ECONOMIC POLICY INSTITUTE, FORMER GENERAL COUNSEL, INTER-AMERICAN DEVELOPMENT BANK, BETHESDA, MD

Mr. LEVINSON. Thank you, Mr. Chairman, for inviting me to testify on this important matter.

It seems to me there are two important points to make so as not to repeat what you've already heard.

First, that the financial plan which was proposed by the U.S. Treasury and was endorsed by the Republican leadership in both Houses, that what is so striking about it is how little it asks of the investors.

In contrast to 1982, when the debt crisis broke upon us, the then-Managing Director of the IMF, Mr. De Larosiere, insisted that the banks stay in, at least to the extent of financing current interest payments, before the IMF would commit itself to taking a leading role in trying to resolve that problem.

That principle, that the investors—in 1982 it was the lenders—bear some part of the responsibility and of the pain of resolving the problem, has been abandoned in this particular scheme.

I think that is a very unfortunate departure. I think what should have been done is that the investors, when they came forward to present their Tesobonos for redemption, should have been told they can get some part of it immediately, but some part has to stay in and be converted into a note of some sort, 3 to 5 years, and paying some international rate of interest. Then, if the U.S. Government had stood behind that, it would be a more reasonable and politically feasible operation and would have preserved that important principle that the investors or the lenders, who took advantage of the high interest rates, bear some part of the responsibility for resolving the problem.

Now, as Mr. Livas very graphically described, and I think accurately so, the underlying premise of the program is that you can put Humpty Dumpty back together again and that, by the U.S. Government stepping in to guarantee repayment of these Tesobonos, the owners of these Tesobonos would convert them into new obligations, rather than cashing themselves out.

As I understand it, that has not really happened. You're really making a colossal bet on that one premise and the failure of that premise means that the basic underlying assumption of the program falls.

Now, I believe that the Mexican government has been very clear, their high officials, that they do not believe this can be done. They are opting for a different strategy; that is, to attract more foreign investment, foreign direct investment, to produce not for the Mexican market, which has collapsed completely, but for export to the United States.

Mexico is not Brazil or Chile. Mexico's exports go 80 percent to the United States. Brazil's exports go one third to Europe, one third to Japan, and one third to the United States, about the same disposition more or less of Chile.

In Mexico, when we're talking about exports, we're talking about exporting to the United States.

The Mexicans don't want to rely on this highly volatile, short-term money which has been such a disaster for them. They are looking toward attracting much more foreign investment for productive purposes, but to export back to the United States.

As I understand it, they are registering three to four new maquiladora operations per day, all designed to export back to the United States.

Now, the question is, and you, I would think, are in a far better position to evaluate than me or any of the rest of us here, how long is that going to be politically feasible at this end, as the numbers become apparent and as Mexican goods come in?

With the 40 percent devaluation of wages, these operations are enormously profitable for the companies and we're going to have a flood of Mexican exports competing with American producers or displacing American producers, some of whom will move to Mexico.

Is that a politically feasible, long-term basis for financing Mexican development?

I don't think it is. I think there will be a reaction here, as well as a reaction in Mexico, to the collapse of the real economy, which you have heard so graphically described.

It seems to me that there's a fundamental contradiction in this program. It's based upon the assumption that you can persuade the Tesobono investors to roll over their investments into new financial obligations.

You're squeezing the real economy in Mexico very drastically and, thus, increasing social and political tensions.

This money is very short-term, highly volatile money. These are not the commercial banks which look 50 years ahead to where they want to be and decide they want to be in Mexico or these other countries and are prepared to ride out what they consider to be short-term storms. This is money which will turn on a dime and run for cover at the first instance of political and social instability, as we saw with the Chiapas rebellion in January 1994. At the same time, your economic program is almost guaranteed to increase those social and political tensions. You're creating exactly the conditions which are going to lead to this money breaking away and not rolling over.

So I think there are some very fundamental contradictions in this program. What we really have to think about, and I hope you will lead the way, is what is the long-term basis on which we are going to continue to finance countries like Mexico, and what is a sustainable basis, both in Mexico and in this country?

We tried the commercial bank financing in the 1970's, the explosion of commercial bank financing, which resulted in the debt crisis of the 1980's. We then had the emerging markets hustle of the early 1990's, which has led us into the Mexico bailout. Now the Mexicans are launched, in reaction against that, on the foreign direct investment export to the United States.

I suggest to you that that's not going to be politically viable at this end.

What we really have to confront is, what is the basis which can be politically sustained here and in Mexico on which a sound, long-term basis of financing Mexican development, in which we as a Nation have an interest, can be put together? It has to be a much more balanced approach of multiple sources, rather than the kind of lurching from one extreme to another that we've seen.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Levinson. Senator Faircloth has a question.

Senator FAIRCLOTH. Mr. Levinson—and thank you, Mr. Chairman, as I do have to leave.

Who made the decision and where was it made that the Tesobonos would be paid back to these investors? Of course, they went there for the simple reason—the high interest rates.

Mr. LEVINSON. Exactly.

Senator FAIRCLOTH. Who made the decision and who was foolish enough to believe that they would return the money to the country once they got their hands on it?

Who made the decision to pay them off?

Mr. LEVINSON. As I understand it, this was a decision, a joint decision, of the Mexican authorities and U.S. authorities and the International Monetary Fund and the World Bank, that this was the most desirable way out of this.

Now, you know the arguments that were made at the time, that if they didn't do this, that the contamination would spread to other countries, that Argentina and Hungary would go down, Thailand, et cetera.

I've always felt that that was a highly exaggerated scenario. If there was unease between the investors, it was because of Argentine and Hungarian reasons. Hungary had a neocommunist government, which had recently been elected, which called into question its commitment to reform. Argentina was equally dependent upon this short-term, volatile capital. So I'm a little bit skeptical of this contamination argument, frankly.

But the decision, as I understand it, was made in the U.S. Treasury, in the International Monetary Fund, in conjunction with the Mexican authorities, and discussed and cleared with the congressional leadership in both Houses of Congress, which endorsed the scheme.

Senator FAIRCLOTH. I was not one of the endorsers.

The CHAIRMAN. Thank you, Senator Faircloth.

Mr. Sanchez.

OPENING STATEMENT OF ALBERTO SANCHEZ VICE PRESIDENT AND SENIOR ANALYST, DEUTSCHE BANK SECURITIES CORPORATION, NEW YORK, NY

Mr. SANCHEZ. Thank you. We in the research department at Deutsche Bank Securities have produced several reports about the Mexican banking system. The last one we produced on May 4, 1995, points out several inconsistencies in the figures that the banks have presented and some accounting changes that they've done.

The main purpose of this report was to highlight investors' concern about the way some banks are reporting first-quarter figures and give a guide of how to best assess the information provided.

The issue of information regarding Mexican banks is a two-way problem.

First of all, maintaining confidence.

We understand that on one side, Mexican authorities and bank managers know that confidence is essential to avoid bigger problems like a run on deposits. That has happened in other countries like Venezuela.

One method used world-wide—not only in the Mexican case—is to suppress bad news.

Other efforts of the Mexican government include the creation of Unidades de Inversion, or the temporary capitalization program per capita, et cetera. That's what we try to explain in our report.

We regard these visible efforts as pointing in the right direction, as long as sufficient information continues to be available.

We feel that they can change the accounting methods and the accounting system as many times as they want, as long as they provide enough information for us to keep doing our job and recommending investors to invest in one or other of the banks.

The CHAIRMAN. Mr. Sanchez, have you had occasion to examine the earnings of the various Mexican banks as they have reported them, and then compared them to the reports by the Federal Reserve, our country's Federal Reserve?

Mr. SANCHEZ. Yes, I have.

The CHAIRMAN. Would you care to comment—we put up some of them over there. Look at the Banamex in column one.

Mr. SANCHEZ. Yes.

The CHAIRMAN. I think they indicate that they earned for the quarter 440 million pesos. When we readjust it and look at it using standard accounting practices, the Federal Reserve has indicated that they really lost—I think that little symbol over there is for a loss of 1.745 billion Tesobonos. So, instead of making approximately $50 million or $60 million, what you really have is a loss in the area of close to $500 million.

Is that right?

Mr. SANCHEZ. In the case of Banamex, it's between a $400 million to a $1.7 billion loss.

The CHAIRMAN. Yes. In other words, they claim a $440 million gain when, actually, they had a $1.7 billion loss.

Mr. SANCHEZ. The problem we have with the way the earnings were reported is that we don't protest if they tell us what the accounting changes they've done are, and if they compare the first quarter of 1995 with the first quarter of 1994, with the same accounting principles.

What is misleading to investors is that some of the banks have compared these figures with figures with different accounting principles.

In Banamex, you see accounting changes.

The CHAIRMAN. Do you know some of those changes? For example, when they have nonperforming loans, I understand this report does not take that into account, but actually reports that they are

not paying interest as earning money and then puts it into its income chart as earned money.

Mr. SANCHEZ. It's a bit more complicated than that.

The CHAIRMAN. OK.

Mr. SANCHEZ. The accounting is accrued, but it's done by all the banks in the world. The banks accrued interest——

The CHAIRMAN. Right.

Mr. SANCHEZ. —even though the cash is not coming into the bank. That is a normal practice and Mexican banks do it.

The problem is that some banks, like Banamex, were not accruing interest on some loans, but then they decided this first quarter to start accruing interest on those, even though the cash was not coming into the bank.

The CHAIRMAN. Isn't that what I've said? In essence, without using the word accruing, if someone is not paying their interest and the loan is not performing, to indicate that it is performing and that you are making profits when, indeed, no cash came in, and it's really, in essence, a nonperforming loan.

Aren't they giving people misinformation?

Mr. SANCHEZ. Yes and no.

The CHAIRMAN. You could run for politics.

[Laughter.]

Mr. SANCHEZ. The case is that, if you owe a bank a loan that is due in 3 months, the bank starts accruing interest every day. You might say that loan is nonperforming. We don't know because the due date is not in yet.

When the due date comes in and you don't pay interest, that is when the loan becomes nonperforming.

So let's say it's logical to accrue interest on something that you don't know if you're going to be paid for. Of course, a lot of people, and Mexican bank managers, know that a lot of these loans they're accruing interest for will never get paid. But that's a different thing.

I think the adjustment that the Federal Reserve analysis has done, and other analysts like ourselves have done, is just pointing out how misleading some bottom-line figures can be if the figures are not properly analyzed.

The CHAIRMAN. Would you have to agree that, if you took the Federal Reserve figure as compared to the earnings reported by Banamex, Bancomer, Serfin, Mexicano, Comermex, and Internacional, if you took every one of them, with the exception of Mexicano, they show earnings. They show a profit.

Mr. SANCHEZ. Yes.

The CHAIRMAN. Then, if you look at the Federal Reserve's figures, every one of them show very substantial losses. They show readjusted net income and they show that there was no net income, but, indeed, they lost.

You don't have any trouble with the Federal Reserve's numbers, do you?

Mr. SANCHEZ. No, no, I don't have any problem. I agree with you. They all should have shown losses if the figures were adjusted according to those parameters.

The CHAIRMAN. Now, isn't it a danger to run an operation where you're telling people that you're earning money, that you're earning substantial monies, when you're really losing money?

Mr. SANCHEZ. There's a danger because you will break people's confidence, not only in the banks that are in bad shape, but your shadow of doubt will go all over the banking system.

There are good banks in Mexico. The problem for us analysts and investors is to tell which banks to invest in and which banks not to invest. If they start creating with accounting changes different reporting of the figures, then it's very difficult for us to tell.

But, yes. If the figures were reported according to these adjustments, they would all have to show losses. We think there is no shame in showing losses. During the American banking crisis, huge American banks showed enormous losses. Investors analyze the figures and make the decision. I think there is no shame in that.

We think it's a pity that the Mexican banks don't understand this.

The CHAIRMAN. Do you think it's the Mexican banks or the Mexican government?

Mr. SANCHEZ. I think it's both because, clearly, Commission Nacional Banceria and Mexican banks are working together in analyzing the figures and presenting them.

The CHAIRMAN. Hasn't the Mexican government conceived of this new methodology where they can transfer off into a trust some of these loans and, therefore, not show them as nonperforming?

Isn't that one of the methodologies in which the Federal Government has loaned itself to?

Mr. SANCHEZ. Yes, that's the UDI program.

The CHAIRMAN. Yes, the UDI program. The result of that is the payments keep growing. The debt keeps growing and growing and growing exponentially, so that while you may not show it as a debt, it's there, and at some point in time has to be redeemed.

Right?

Mr. SANCHEZ. Yes, that's right. You will have to pay at the end a balloon.

The CHAIRMAN. It's what we call a balloon.

Mr. SANCHEZ. Yes.

The CHAIRMAN. This balloon is being blown higher and higher and getting bigger and bigger.

What do you think the likelihood of them being able to redeem those UDI's is?

Mr. SANCHEZ. Only the companies that are able to grow faster than inflation will be able to pay that. Those that are below inflation would not be able to pay it.

The CHAIRMAN. Are there very many companies that are growing faster than inflation?

Mr. SANCHEZ. We don't know yet. It's difficult to assess at this moment. There are some companies that will be able to. Others won't. But, basically, the exporters will be in better shape than the nonexporters.

The CHAIRMAN. Thank you very much, Mr. Sanchez.

Dr. Weinstein.

OPENING STATEMENT OF DR. BERNARD L. WEINSTEIN DIRECTOR, CENTER FOR ECONOMIC DEVELOPMENT AND RESEARCH, PROFESSOR OF APPLIED ECONOMICS, UNIVERSITY OF NORTH TEXAS, DENTON, TX

Dr. WEINSTEIN. Thank you, Senator D'Amato. As a former New Yorker now living in Texas, I appreciate the invitation to be here.

I'm just going to make a few comments because most of the points in my prepared testimony have already been covered.

I do want to quote a noted Mexican professor, columnist, and author, Jorge Castaneda, who recently asserted that Mexico is in the midst of a meltdown. I guess that's his metaphor for falling apart as a result of the turbulent economic, political, and social conditions there. If you know Professor Castaneda, he's often given to hyperbole, but I think he's right on target when it comes to the condition of the Mexican economy today, and, particularly, its banking system.

Regrettably, there's a lot of dissembling going on. I refer, for example, to a headline in the business section of yesterday's Dallas Morning News. The headline says: "Mexico Crisis Over, IMF Says." It quotes the head of the IMF, Mr. Camdessus, saying the following: "Mexico's economy has moved from a crisis to a manageable problem."

From what we've heard this morning from both panels, that's clearly not the case.

I'm not going to recite a lot of statistics, but maybe just point to a few things that haven't been brought up so far.

One of the consequences of this spike in interest rates is that many state and local governments in Mexico are having difficulties meeting their debt obligations. Much like Orange County in California, these subnational governments may be forced into bankruptcy. Of course, unlike Orange County, California, most state and local governments in Mexico don't have the financial wherewithal to bail themselves out.

Also, the official projections of decline in Mexico's gross domestic product are clearly understated. They're talking about 2 to 3 percent. Private economists believe the contraction will be more on the order of 5 to 10 percent.

We've heard a lot of talk about how small businesses and the middle class have been affected by this crisis and by the high interest rates and the fact that the bailout isn't really helping them at all.

That's absolutely true. There are at least one-half million engineers, managers, accountants, bankers, and other professionals that have been thrown out of work in recent months. In a manner of speaking, the peso devaluation has brought about the disenfranchisement of Mexico's middle class. That's probably the most serious social problem that Mexico is dealing with.

Mr. Levinson was talking about the new interest in maquiladoras, many of them right across the border from Texas.

One of the benefits, if you will, from the devaluation is that Mexico's exports are way up. Even though their total industrial production is down by about 30 percent, exports are up about 25 percent from a year ago. Of course, what's positive for Mexico may be negative for the United States. Last year, Mexico was one of the

few countries that we had a sizable trade surplus with. This year, that surplus will probably become a deficit of $12 billion, putting Mexico third behind Japan and China.

In Texas, we see a lot of the impacts of the devaluation and the spill-over. Retail sales in U.S. border towns are down 30 to 80 percent. Apprehensions of illegal immigrants are up 40 percent from a year ago.

We read a lot about the drug trade, political corruption, and all of that. I'm an economist. I don't want to get into those issues, although they're obviously related.

Let me make a couple of comments about the banking system. I don't profess to be an expert in banking, but there's a certain deja vu for me as a Texan because we had a financial crisis, a banking crisis, and an S&L crisis in Texas a decade ago that eventually spread to the rest of the country. I see a lot in Mexico's current financial emergency that mirrors what happened in Texas a decade ago. We hear talk about an inadequate capital base, rising loan losses, inexperienced management, and a sky-high cost of funds. These are all things that we saw in the United States with our own bailout program a decade ago. I'll also remind you, Senator, that some of the initial estimates of the cost of the S&L bailout were in the $40 billion to $50 billion range, but the final costs were more like $400 billion. I worry that we may be getting ourselves into a similar situation in Mexico.

As you know, Mexico is talking about allowing foreign banks to gain 100-percent control of weak and failing domestic institutions, just as we did in Texas. When our institutions failed, we invited foreigners from New York, North Carolina, California, and Ohio to take over all of our banks.

We don't have any banks in Texas today. They're all owned by Easterners, Midwesterners, and Californians. All of those acquisitions, of course, were done with the assistance of the American taxpayer.

Now, what's going to happen in the weeks and months ahead? We don't really know. We've committed $20 billion so far. It seems to me additional American assistance to shore up Mexico's banking system is inevitable since most of the initial funds have already been committed. About $16 billion of Mexico's current short-term debt is owed to American individuals and institutions, and, in essence, the February agreement makes those lenders whole. In other words, we are bailing out ourselves, for the most part. If American banks are going to increase their investments and exposure in Mexico as part of a global recovery effort, they're surely going to require additional loan guarantees from Washington or the International Monetary Fund.

Thank you. I'd be pleased to answer any questions you may have.

The CHAIRMAN. Mr. Whalen.

OPENING STATEMENT OF CHRISTOPHER WHALEN CHIEF FINANCIAL OFFICER, LEGAL RESEARCH INTERNATIONAL, WASHINGTON, DC

Mr. WHALEN. Mr. Chairman, I've prepared written remarks and I think, rather than go over ground that we've covered very well, I'm going to do something I've become famous or infamous for in

Mexico, which is to stick my neck out and tell you what I think is going to happen next.

By and large, the collapse of the banks in Mexico is inevitable. It's really a waste of time to go over the figures and statistics that they issue on their balance sheets and income statements for the simple reason that we have no reason to believe that these figures are accurate, and we have every reason to believe, to use the vernacular, that they're cookin' the books.

Let me just throw out one fact.

Mexican banks hire their own auditors. Mexican regulators do not have the capacity to go in and do a full-scope audit of their banks in the way that the Fed, the Office of the Comptroller, and our State regulatory agencies attempt to do that. Regulation is always an after-the-fact exercise. You always have the train wreck and then the regulators come in and clean up the mess.

But, in Mexico, bank balance sheets, their statements of asset quality, their statements of morbidity and loan portfolios, are really just fantasy. What you have to do, I think, is look at the economy as a whole, look at the microeconomy, the examples that were brought to you today in the first panel, and infer from the particular to the general that if the productive economy in Mexico is going down the tubes, it's pretty likely that most banks have not only wiped out any earnings, but really have wiped out their capital several times over and are profoundly insolvent.

I really don't think there's any other possible conclusion.

Even the smaller banks, which at the end of 1994 had relatively clean loan portfolios and which were in pretty good shape, the clean banks that were referred to before, are compromised in this bad economic environment.

You cannot have good banks in a bad economy. We've seen this in Venezuela very graphically. So banks, insurance companies, broker/dealers, Casas de Cambio, and the foreign exchange houses are all, in one way or another, going to have to be nationalized.

Now, the good news is they're probably not going to allow any more nominal bank failures in Mexico. That is to say, forced closures.

The bad news is that the inflationary cost of maintaining liquidity for the banks, providing liquidity to states and localities who are now seeing their revenues fall away as the economy implodes, is going to be extraordinary.

I think, by definition, we're going to see hyperinflation in Mexico. We're going to see even official price increases go well over 100 percent for 1995.

The next logical conclusion from that——

The CHAIRMAN. What is the impact of that kind of inflation?

Mr. WHALEN. It will certainly discourage foreign investment and it will increase an already torrid flow of capital flight out of the country.

As one of the earlier panelists suggested, we may have to think about formally dollarizing the Mexican economy and just abandoning the peso entirely because there's so little confidence.

If people don't want to use money, they will inevitably put their wealth and their income into other sources.

I'll tell you, Mr. Chairman——

The CHAIRMAN. Is that something that you think, politically, is acceptable? It would seem to me just——

Mr. WHALEN. Oh, no, no.

The CHAIRMAN. Can you imagine how the Mexican people, saying now we're going to—it's one thing to use it, but it's another thing to have your national sovereignty, so to speak, totally stripped away.

Mr. WHALEN. I quite agree. But the problem is that the ruling party in Mexico has for well over 150 years played this very interesting arbitrage between the local currency and hard currencies.

Past governments would invite foreign investment. When they got a certain amount of foreign money in the door, they would devalue, trapping the investment, then they would default.

I would remind you that the United States wiped off Mexico's debts in 1959. We've been through this before. Our fathers and our grandfathers knew what we should do in 1982 and they know what we should do now, which is debt relief and forgiveness, and a complete end to new lending, particularly from the IMF and the World Bank.

That's the answer. It's called cash.

The best aid we can give Mexico is trade, by forcing them back into productive—I hate to say it—export-led growth.

The CHAIRMAN. You say debt relief instead of bailing out people who have made investments.

Mr. WHALEN. That's right.

The CHAIRMAN. The only thing that we've done is to exacerbate the problem——

Mr. WHALEN. That's right.

The CHAIRMAN. —by increasing the huge debt and saying, you, the Mexican people, owe this, and by bailing out people who went in there, foreign investors who took their chances, notwithstanding that a significant portion of them may have come from this country.

Mr. WHALEN. I think the best thing for the U.S. Government to do would be to wipe out all of their public sector debt. It's about $90 billion, the IMF, World Bank, all of them. Forbid new multilateral public sector lending. And let the Mexicans make their own deal with the private creditors.

I think they could work something out.

Look at Chile. The best thing that ever happened to Chile was being cut off from the United States. It forced them to focus on trade and on making money. That's now the strongest economy in this hemisphere, outside of our own.

The logical conclusion of the collapse of the productive sector in Mexico, and I think the imminent repeat collapse of the speculative sector, what everyone points to when they say it's recovering, is a debt moratorium.

If you see individuals, companies, and states in Mexico on the brink of default or, in fact, in default, it's not a big leap to come to the conclusion that the entire economy is headed in that direction.

Let me give you some numbers.

If we want to be very generous and assume that exports in Mexico net of the maquiladoras—that's the real figure you've got to

look at, their core exports, excluding the assembly plants. Let's say that number gets up to $30 billion this year, to be very optimistic. That's about equal to their fixed-debt service.

In other words, amortization and interest on their fixed foreign debt, public and private, not the Tesobonos, not CETES, and not bank deposits, just their contracted foreign debt, is going to be about the same number.

What does this mean?

It means that Mexico is insolvent, by any classical definition. It also means that, by definition, in order to buy food that they need to feed their people, in order to buy refined energy products, feedstocks for industries, et cetera, et cetera, Mexico must run a net deficit which they will look to us to help subsidize.

This is the key distinction: Either the Mexicans are going to pay debt for a little while longer or they're going to buy our goods. But they can't do both.

That's just the basic reality here. Our ancestors knew that when a debt got to a certain size and a certain unwieldiness, if you will, you had to forgive it. The debt is gone. It was contracted in bad faith. Much of the monies—there's almost a one-for-one between capital flight from some countries like Mexico and Argentina and foreign investment.

The money comes in. It goes right into the pocket of the elite groups that run the country, the business groups, and it goes right off to a bank account in San Antonio, New York, or Switzerland.

The secondary result of this coming moratorium on foreign debt is that both the World Bank and the IMF are going to come to you, Mr. Chairman, and to other Committees in Congress looking for more money, because they are also Ponzi schemes. They are also insolvent in a profound sense.

In fact, I would bring to your attention one very disturbing trend I see with the World Bank. As they've been running out of money for clients like Mexico, Argentina, and Brazil, they've started extending to off-balance sheet guarantees. They guarantee private lending to these countries and they put the obligation on their book as a contingent guarantee, and it's ballooning.

The World Bank, I think, is one of the great threats to global financial stability today because they must keep coming back to the member nations for more cash—capital, they call it—so they can go out and borrow more money to lend to people like Mexico, which, by the way, is their largest client.

Obviously, political instability is going to be the result of the continuing implosion of the productive economy in Mexico. But let me say it's been alluded to by some of the earlier panelists that some industries may be able to survive in this environment we have in Mexico.

There's only one industry, Mr. Chairman, that can thrive in an environment like this and it's narcotics. The biggest clients of the banks in Mexico are the narcotics traffickers. They're the ones with money. It's clear that the illegal sector in Mexico is the only sector that's growing right now. People who are thrown out of work, people who can't feed their children, they oftentimes will consider that alternative.

The other alternative is immigration.

You have a situation now where the relative power of the oil sector is declining, the technocrats who were in the Salinas regime who had access to foreign money have lost their power because they can't get any more money from credulous foreign investors.

The only people sitting at the political table in Mexico today who have money in their pocket are the drug dealers. That's why their political power is in the ascendancy.

This is the end result of bad economics.

Finally, let me point out to you something that I think is very important.

I could make the same comments that I make about Mexican banks, about Chinese banks, or Argentine banks, or banks in any number of other emerging markets, banks that are rolling bad credits, that aren't recognizing losses, that are essentially allowing their assets to grow at 20 and 30 percent when the economy is deflating.

When I worked at the Federal Reserve Bank of New York as a young analyst in the bank supervision area——

The CHAIRMAN. You would still be a young analyst.

Mr. WHALEN. Yes. I hope so.

[Laughter.]

One of the first things they taught us was that when you see a number on a balance sheet going up 20 or 30 percent a year, you better go find out why. When you see the rate of asset growth that we've seen in Mexican banks, even in years when they said that inflation was down around single digits, you know what they're doing. They're rolling bad credits.

There's a global phenomenon of deflation that was the result of the Federal Reserve's excessive reduction of interest rates after 1989 to solve our bank problem. This wave of high-powered money rolled offshore to markets like Japan and many of these smaller emerging markets. Now that interest rates have gone up since February of last year, the great casino in Mexico City is collapsing.

My fear is that our economy is going to slow down and we are also going to feel this tail-lash of deflation, this loss of jobs, this loss of industrial capacity that you see in Mexico.

I would point out to you that there are enormous financial problems in China right now for the same reason. I'm not saying that one should excuse anything that's going on in Mexico as part of a general problem, but there are certainly relationships here that are important.

I'll end it there, Mr. Chairman.

The CHAIRMAN. I want to thank you for your observation.

Mr. Levinson.

Mr. LEVINSON. I only want to complement what Chris said with the following observations.

It's not so easy, or going to be so easy, to renegotiate a debt moratorium. Under the Brady plan, remember, of debt reduction, the remaining debt is guaranteed by zero-coupon U.S. Treasury bonds which are on deposit at the New York Fed.

So, if Mexico doesn't meet its payments, the banks can come in and claim—and it's something like $7 billion that sits in the Fed today, the New York Fed, as a guarantee of that debt.

Now, the other thing which I think is relevant for you, of course, is what he said about the World Bank.

You will recall that in the late 1980's, the World Bank and the Inter-American Development Bank were making what they call the structural adjustment loans, program loans. They went to the central bank and were used for general imports.

They disbursed faster but they have to be repaid faster, and Mexico and Argentina are now net-negative with the World Bank. That is to say, they are repaying more than they are receiving.

It's like being on a bicycle. If you don't keep peddling, in effect, the World Bank is going to be taking out very substantially more from Mexico and countries like Argentina, which they loaned so heavily to in this form of lending.

The CHAIRMAN. So you have a situation where a man is just sinking by weight of the obligations piled on him. If you say they are actually paying back—this is something that I've just learned—more than they're getting from the World Bank——

Mr. LEVINSON. That's exactly right.

The CHAIRMAN. —they're losing ground on that operation.

Mr. LEVINSON. With respect to the World Bank, Mexico is over the World Bank's single-country limit, and it has been for some time.

The World Bank and the IDB have now come in with billions to shore up the Mexican banking sectors. Again, if you go back to what was said before with respect to the privatization, who bought the banks in Mexico as part of this privatization?

If you recall, at the time that these were bid, it was the most powerful Mexican financial groups that bought these banks. Then, as the Salinas government was following its high interest rate policy to avoid a devaluation because it had bet the house, the mortgage, and the family jewels on getting the NAFTA through, and a devaluation would have exposed the central myth of the NAFTA that you could run a $9 to $12 billion trade surplus, the United States with Mexico, thereby providing 200,000 net new jobs, which was the basis on which it was sold to the United States, these banks increasingly borrowed abroad.

So they have a large, a very large, foreign exposure primarily in dollars to U.S. creditors. As we've heard, as the domestic economy has collapsed, they aren't able to collect the pesos to make the payments.

In comes the World Bank and the IDB with more of this liquidity, which again disburses fast and has to be repaid fast.

So the situation isn't only Tesobonos. It's very much more complicated across the board.

The CHAIRMAN. Dr. Weinstein.

Dr. WEINSTEIN. I really think the point has to be emphasized and reemphasized, as we heard this morning, that there's nothing in the financial aid package that's helping to improve the real economy of Mexico. Unless the real economy of Mexico improves, the financial problems are going to persist.

The CHAIRMAN. I think that is so important. If we're giving aid and it is helping the patient, helping the economy of Mexico, then you can make a case for that.

When you're giving aid that is not doing that or is doing it in such an insignificant way, then it's rather frustrating to see us taking these resources, these scarce resources, and, basically, if anything, exacerbating the problem, not solving it.

Dr. WEINSTEIN. A decade ago, a small business could not get a loan in Texas unless you were willing to pledge your home, your wife, and your first-born.

It's the same in Mexico today. There is no capital available to help small businesses grow.

In fact, as we've heard from several presenters today, small businesses have been hurt more than big businesses. If you compound that with the fact that Mexico has a very low savings rate, even lower than that in the United States, it's very difficult, even with the sky-high interest rates that are being offered to depositors, to accumulate domestic capital.

The devaluation clearly worsened the income distribution problem because, in a curious way, the rich got richer because they had most of their assets in dollar-denominated form.

The CHAIRMAN. Mr. Sanchez.

Mr. SANCHEZ. I want to point out that our view is not as negative as that of many other people here.

I think that not all of the banks are in bad shape. Not all the companies are in bad shape. The Mexican situation is not as dire as people are pointing out.

There are some good banks. There are some good companies. They should get the benefit of their good management after the recession is over.

As analysts and investors, the only thing we ask is to be provided with clear information. We want to make good investment decisions. We know that there are people willing to invest in Mexico, to invest private money, because there are good opportunities in Mexico. They believe in the country and they believe in some of the companies there.

We only ask to be supplied with a reasonable amount of information, as much as possible, and the private money, I can assure you, will flow to the right sectors and to the right banks.

I think that's also key for the country.

The CHAIRMAN. I want to thank all of the panelists for coming. I want to apologize for the delay. As I explained before, we had six votes back to back.

If there are any other observations that you want to make, we're delighted to hear them. If not, we stand in recess, with the thanks of the Committee.

[Whereupon, at 1:30 p.m., the Committee was adjourned.]

[Prepared statements supplied for the record follow:]

PREPARED STATEMENT OF JAVIER LIVAS

PAN Member, Finished Second in Last Presidential Primary for PAN Candidate, Businessman and Analyst of Political System, Mexico City, Mexico

May 24, 1995

Summary

According to the latest financial figures, the Mexican economy is beginning to stabilize and recover from the devaluation shock. The real economy, however, is just entering its worst crisis in decades. This is the fact we should be willing to face.

The Mexican government has always been very good at manipulating economic figures. We have had a taste of this on many occasions. All of last year we were told that things were going fine, that Mexico was on the verge of becoming a First World economy. We all know what happened on December 20, 1994.

With the help of a $50-billion-plus rescue package, the post-devaluation financial figures have been making significant improvements:

Peso/Dollar Exchange Rate. The latest figures show that the peso, currently at about 5.9 to the dollar, has appreciated approximately 22 percent from its lowest March 9 figure, which was at 7.6 per dollar. It is estimated that the undervaluation margin is now only 8 percent, instead of an estimated 55 percent high.

Peso Interest Rates. Interest rates have fallen sharply, about 25 percent in the last 2 months. The CETES 28-day interest rate, which the whole Mexican economy uses as reference, was at a level of 83 percent on March 23 and has dropped to about 58 percent.

Tesobonos. The privileged Tesobonos, Mexican treasury bonds payable in dollars, have decreased significantly. The figure stands at $12.5 billion, down from the original $27 billion, a 60 percent reduction.

Balance of Payments. Exports have surpassed imports in a notable way. The first 4 months of 1995 show a surplus of about $785 million. The same period last year shows a deficit of $5.7 billion.

The Stock Market. Anyone who invested in the Mexican stock market in early March would have gained a 38 percent profit. Brady bonds have increased their price by 34 percent in the past 7 weeks.

Budget Surplus. The Mexican government had a budget surplus of $1.5 billion in the first quarter of 1995. The price of oil has also helped Mexican public finances given that it rose 38 percent.

International Reserves. Mexican reserves in the Banco de Mexico have grown about $2 billion, from $6.2 billion in December to $8.3 billion on May 12.

All these figures are shown with pride by Mexican officials. What is not considered is the excruciating pain that the real economy is going through. The real economy lags far behind the optimistic figures:

Recession. Mexico is in the midst of a full-fledged recession. Economic activity, measured as Gross Domestic Product (GDP), is expected to decrease by 4 percent this year compared to last. After 10 years of close to 2 percent yearly economic growth, very low for an underdeveloped nation, the ordinary Mexican people are paying a dear price for financial stabilization.

Unemployment. Unemployment figures are impressive. Approximately 49 percent of the work force is jobless or holding marginal occupations.

Interest Rates. Money in circulation has decreased by 34 percent in real terms in the first 4 months of this year. Interest rates have skyrocketed to levels exceeding 120 percent. Loans are virtually nonexistent and loan renewals are frowned upon by debtors who are waiting for things to settle down. Although interests have gone down, they are still very high compared to international levels. The real interest paid abroad is draining Mexico of much needed resources. In these conditions it is impossible to grow.

Unpayable Loans. The best indicator of the recession is the inability to comply with debt obligations. Bad loans have increased and banks are forced to renegotiate debts at longer repayment periods. The UDI, a new investment and loan unit created by the government, has not gained substantial credibility and is therefore not being used as much as it was supposed to. Debtors fear that subtracting inflation from interest payments will only create a time bomb.

Small- and Medium-Size Business. This is the hardest hit part of the Mexican economy. Tens of thousands of all kinds of business concerns are closing their doors or ceasing production. Layoffs amount in the hundreds of thousands. Internal consumption is falling.

Inflation and Falling Wages. The income of the average worker is taking a beating. While inflation has increased about 23 percent in the past 4 months, wage increases have barely reached 10 to 12 percent.

In light of the above, I am concerned that the enormous sacrifice to bring back foreign investment will not have time to work and may easily end up in unprecedented social unrest. The economic medicine may in fact kill the patient. A dangerous feeling of helplessness is invading the country. Behind the helplessness are the following circumstances:

- People do not trust the Zedillo government at all, and find Zedillo's leadership lacking in many aspects. The value added tax was increased 50 percent by the PRI-controlled Congress, in spite of nation-wide disapproval.
- The Mexican political system is beyond reform; it is too corrupt to heal itself. Reform accords are not seen as important issues and have been broken by the parties involved.
- The bailout package has not helped the real economy. The $10 billion already disbursed by the U.S. Treasury Department has been earmarked to repay Tesobono obligations.
- The help from the United States is therefore seen with suspicion. Mexicans of different backgrounds converge on thinking that the United States wants to help itself to Mexican oil.
- Recovery signs remain as macroeconomic figures that are far removed from the everyday experience of millions of Mexicans that are having trouble making ends meet.

Conclusion

The number one Mexican priority is growth. Without it we could be facing a terrible social and political crisis in the very near future.

Without focusing on growth it is very unlikely that the loans from the United States will ever be repaid. A shrinking economy cannot afford to pay higher interests and repay a mounting international debt.

It is expected that our new trade partners will understand this as an urgent situation. Money can be channeled through the banking system to prop up the small- and medium-sized businesses that are the backbone of job creation and production.

Any new moneys loaned to the Mexican government will not reach the small- and medium-sized businesses or the ordinary people.

I would assume that the Congress of a Nation rich in economic experience should understand the critical situation that its neighbor to the south is facing and would do something to help. The consequences of not doing so on time can be far reaching.

Thank you.

FORO de
cambio
EMPRESARIAL

May 22, 1995

A presentation by Gabriel Hinojosa to:
United States Senate
Committee on Banking, Housing and Urban Affairs
Mr. Alfonse D'Amato
Chairman

I would like to express our appreciation for the interest you have shown regarding our opinions about our problems and possible solutions. I hope that by accepting your invitation we may help you to get closer to the truth.

TABLE OF CONTENTS

D1 (Document #1). This is the material I will refer to in the hearing, it contains a summary of our opinions about the problems, roles and solutions for Mexican small business.

D2. A document titled "Ideas de Cambio", which was presented on April 29, 1994 to the national leaders of the private sector in an attempt to alert them about the consequences of the wrong economic policy implemented by Carlos Salinas. If you are able to translate the first page you will find it rather prophetic.

D3. This article was published by our group on November 28th, 1994 in a national newspaper, (El Financiero) , before Mr. Zedillo took the presidency of our country, and contains economic suggestions.

D4. A brief personal curriculum and a short description in English of our groups "Constitutional Document."

OTHERS. I will give to Holidae Hayes, (202) 224-7391, Mr. D'Amato's staffer, other documents which could be complementary to the above, such as newspaper clippings which show how police units are using force to "clean" food markets of informal vendors with more than 30 people injured just one week ago. Others contain economic proposals of the "Consejo Coordinador Empresarial" (the union of most national private sector chambers) that was released a week ago with economic proposals for continous growth. Also included are some other testimonies that different businessmen and workers unions have given me.

SMALL BUSINESS IN MEXICO

I am convinced that any workable solutions to the problems that Mexican society is facing should, above all, create the proper conditions for small productive organizations to survive, multiply and grow. This will only be achieved with a government that is committed to this fact. I will divide this presentation in 3 sections.

1. Why small businesses are right for Mexico.
2. Why small businesses are disappearing.
3. Solutions and corrections.

1.WHY SMALL BUSINESSES ARE RIGHT FOR MEXICO.

*They create more jobs with less capital. We need many jobs and capital is very scarce.
*They do not require highly skilled people, which we do not have alot of.
*They do not require excessive foreign machinery, helping the trade balance.
*They produce quantities appropriate for the small domestic market.
*They take advantage of the existing assets, both human and material.
*They account for more than 80%of all jobs in the formal and informal economies.

2.WHY SMALL BUSINESSES ARE DISAPPEARING.

*The economic model followed in Mexico for several years has not promoted the development of small business units, on the contrary it has given preference to big corporations and hindered the growth of small ones.

*They have had no other option but to go along with the Mexican banking system, which behaves like a cartel, avoiding real competition and charging society too much.

* The needed infrastructure is either nonexistent or operated by the government or some big corporation that charges at will for their services. This is the case of the telephone company, toll road system, gasoline, and electricity.

* As our inefficient government demands more resources, they create all kinds of new taxes, ignoring the important social role that small business plays in the Mexican economy.

*Governmental corruption, and harsh punishment to those who fail to comply with a system that is impossible to comply with, take a very high toll on small business.

* The cost of money is basically set by the cost at which our government is borowing, plus inflation, plus banking mediation which is so high that it could be considered usurious, has made most legitimate business not feasible.

*The market has collapsed as a result of a recessive plan that pretends to stabilize the economic indicators, without taking into consideration the people and future of Mexico.

3. SOLUTIONS AND CORRECTIONS.

*No economic plan will work if we do not recover the confidence in our government which has never been very high, but is now at a historic low.

* Implement an emergency program that eliminates all unnecessary barriers and liberates all possible productive forces. Stimulate national and foreign investment.

*Renegociate the national debt for a longer period, and have fair interest rates.

* Invest as much as possible in infrastructure and education.

* Open the banking sector to all international banks under the same conditions as Mexican banks, and let them support worthy projects and competent entrepreneurs.

*Make sure all international finance goes through as few intermediaries as possible to reach the productive sector, especially the small business area.

*Stimulate joint ventures and increase commerce with our commercial partners (NAFTA) under a strictly blanced relationship that will allow us to grow and pay our debts, enriching the people of both countries.

CONCLUSION.

Unless Mexico recovers its growth by allowing aid to reach the productive sector, serious problems and social unrest will occur. There will be no possibility to pay back loans as no weath will be created. Mexican entrepreneurs with social consciousness are ready to do their part and pay their debts as soon as proper conditions are met.

IdeasdeCambio

Seleccionadas por Gabriel Hinojosa Rivero / Año 1 N° 1 / 29 Abril de 1994

Para salvar a la micro, pequeña y mediana empresa, a cientos de miles de empleos y con ellos evitar las consecuencias que al perderlos traerían para el país, se requiere un cambio de actitud de todos los que integramos la sociedad. El presente documento resume las ideas y peticiones en las que coincidimos la generalidad de los empresarios asistentes a las ocho reuniones realizadas.

Objetivo de las Reuniones: Lograr mayor unión entre los empresarios estableciendo mecanismos que permitan seleccionar las mejores ideas para salvar y crear empresas micro y medianas en manos de Mexicanos.

INTRODUCCION: Estoy convencido de que el cambio más importante que se debe dar en México, es el cambio de actitud de la sociedad civil en un sentido de mayor participación; esto a su vez, traerá como consecuencia que los líderes conozcan la dirección deseada y sientan el apoyo de sus bases para avanzar en el camino correcto.

Problemas Principales:

A.- Mercado Contraido: La demanda de los bienes y servicios es apenas una fracción de lo que puede llegar a ser. La razón de lo anterior es la pobreza de la mayoría de los Mexicanos. La **solución no es fácil, pero sin duda requiere;** desatar, alentar y hasta subsidiar, todos los impulsos productivos. Esta es la verdadera y única riqueza sostenible de un pueblo, y con el tiempo se transforma en abundancia. Es equivocado pensar que la exportación es la solución para el país, aunque pueda ser para algunos empresarios y para un gobierno que desea posponer una crisis de divisas.

B.- Sobrecargas a la Empresa: El distanciamiento y la desconfianza existente entre el pueblo (causante) y el gobierno (recaudadores), ha provocado un sistema complicadísimo de tributación que impone importantes cargas administrativas a ambos lados, así como tributación excesiva a los causantes no evasores. Adicionalmente la empresa soporta la carga de la capacitación e infraestructura deficiente, provocado por el abandono de los que debieran implantarla con los impuestos recaudados.

> *" Se requiere desatar, alentar y hasta subsidiar, todos los impulsos productivos "*

C.- Sobrevaluación: La sobrevaluación de aproximadamente 30% que se estima tiene el peso mexicano, condena a muerte a la mayoría de nuestras empresas que no podrán competir dentro del país contra la inundación de importaciones ni mucho menos exportar.

Habrá quiebra, desempleo y tiendas con productos baratos importados que podremos comprar hasta que se nos termine el dinero. (A los que aún lo tengan).

Para exportar, defender a la empresa y mercado nacional (y yo diría que defender al país de un destino incierto) se deberá resolver de alguna forma, la **distorsión causada por la Sobrevaluación.**

D.- Verdades a medias y mentiras: Los gobernantes, líderes de sector, medios de comunicación, etc., parecen querer aislarnos de la verdad. Disminuyen los graves problemas y magnifican logros y espectativas positivas. Tratar a la sociedad como menor de edad, provoca que no madure y en el caso de los pequeños empresarios, nos lleva en muchos casos a tomar decisiones equivocadas que a veces provocan pérdidas graves y quiebras. Tener información correcta es la mejor base para tomar las decisiones correctas.

SOLUCIONES:

"Plan de Salvamento"

Antes de crear nuevas empresas debemos salvar a aquellas que siendo factibles, estan en peligro de desaparecer por las deformaciones en nuestra economía.

Proponemos se implemente un *"Plan de Salvamento y Creación de Empresas y Entidades Productivas"*. Dicho plan debe ser un mecanismo con el consenso de gobierno, trabajadores y empresarios. Que reconozca la importancia de preservar y crear la mayor cantidad de fuentes de trabajo y riqueza, así como las graves consecuencias que de no hacerlo tendrá para todos.

Las empresas que califiquen por sus condiciones para el plan de salvamento, deberán obtener tratamientos especiales, tales como:

* Recibir en forma automática créditos del gobierno por un importe igual a los impuestos causados con interés igual al que paga el gobierno por los recursos que obtiene, o sea, CETES.
* Suspender aportaciones como SAR, INFONAVIT, Cuotas sindicales y similares, así como cotizar al IMSS en un plan especial de cobertura limitada. No somos país del primer mundo y es irreal pretender dar estos beneficios por ley, cuando el país no ha podido cumplir con un derecho fundamental, el derecho al trabajo.
* Tasas impositivas significativamente menores que a las aplicables a la gran empresa o grupo industrial.
* Contabilidad y requerimientos administrati-

vos super simplificados.

Las empresas que superen con éxito su periódo crítico, deberán:

* Dar acciones de la empresa a los trabajadores, equivalente a lo que dejaron de percibir en prestaciones y sueldo.
* Restituir las prestaciones sociales vigentes a sus trabajadores.

* Pagar al gobierno los financiamientos sobre impuestos.

"Para el país es mejor negocio empresas abiertas que causantes improductivos".

PETICIONES A LAS PARTES:

Además de apoyar el plan de salvamento, pedimos lo siguiente:

Petición a Empresarios:

* Salvar todas las fuentes de trabajo posibles.
* Crear empresas en donde sea posible, sobre todo aquellas intensivas en mano de obra y aquellas que por su ubicación, producto, etc. aporten más a la salud social.
* Participar abierta y decididamente en las áreas sociales y políticas a fín de vigilar la buena marcha del país.
* Cumplir con sus obligaciones fiscales y denunciar a quién no lo haga.
* Capacitar a su personal tanto en asuntos de la empresa como en asuntos de la sociedad en general.
* Consumir siempre que se pueda, materiales e insumos producidos en el país.
* Oponerse a proyectos del gobierno que con fachada de buenos, violan derechos y propiedades de otros mexicanos y otorgan los contratos de la obra pública a extranjeros o a "Empresarios Amigos del Sistema".

Petición a las Cámaras:

* Definir mejor el tamaño y rama de empresas que puedan representar con calidad.
* Actuar según lineamientos de sus representados.
* Establecer consulta y comunicación con sus bases.
* Defender y alentar los valores como la verdad, la democracia, la propiedad, la libre expresión y la igualdad de oportunidades.
* Defender el derecho a la libre asociación de trabajadores y empresas.
* Solicitar e implementar el plan de salvamento.
* Captar oportunidades de negocios, estudiarlos y buscar empresarios que los realicen.
* Romper la dependencia económica de las cuotas obligatorias, sospechosamente "otorgadas" por el gobierno.
* Difundir la realidad económica que afecta a su sector sin temor a la verdad.

"Obtener la información correcta es la mejor base para tomar las decisiones correctas"

Petición a Gobierno:

* Borrar el pasado fiscal de todos los causantes a partir del momento de tregua.
* Revisiones fiscales a los causantes sólo por sorteo público o por evidencia sólida de evasión. Fín del terrorismo.
* Simplificar y reducir las cargas fiscales. Eliminar el 2% y otros.
* Legalizar a todos los causantes sin excepción.
* Eliminar el contrabando y el "Dumping".
* Honradez, transparencia y eficacia en el manejo de nuestros recursos.
* Agrandar, mejorar, liberar y abaratar el uso de infraestructura. Especialmente la de Comunicaciones, como la de teléfonos, carreteras, ferrocarril.
* Facilitar y fomentar la entrada al país de instituciones que otorguen crédito a empresarios mexicanos.
* Dar mayor libertad y autonomía a los Estados y Municipios.

Acerca de la Coyuntura Política Actual:

El momento actual ofrece oportunidades, que no regresarán facilmente, para que podamos influenciar en la recuperación de México. Por lo anterior sugiero apoyemos las siguientes acciones:

FORO NACIONAL EN BUSCA DEL:
"MODELO MEXICANO DE DESARROLLO INTEGRAL"
DOCUMENTO BASE COMPLETO

El presente documento tiene por objeto servir de base para el foro nacional de consulta que se llevara a cabo a partir del 28 de Febrero de 1995 en las principales ciudades del pais que cuenten con organizador local.

INTRODUCCIÓN: Para salvar cientos de miles de empleos, crear millones de ellos y asi evitar las consecuencias que perderlos traerian al pais, se requiere un *CAMBIO DE ACTITUD DE TODOS LOS QUE INTEGRAMOS LA SOCIEDAD*. El presente documento resume los principales cambios que proponemos se implementen en nuestro pais. Un sistema que elimina a la mayoria de los mexicanos de casi todas las oportunidades, es profundamente injusto; por esta razón, el criterio principal en estos planteamientos es anteponer el bienestar del hombre. Todas las fuerzas productivas, en especial los micros, pequeños y medianos, debemos participar intensamente en el logro de un *VERDADERO MODELO DE DESARROLLO INTEGRAL MEXICANO* y actuar reconociendo la *HIPOTECA SOCIAL* que nuestras empresas tienen para con la sociedad mexicana.

CREACIÓN DE EMPLEOS

(02) DERECHO AL TRABAJO: Uno de los derechos fundamentales de todo ser humano es el derecho al trabajo y ampliando un poco más, deberiamos decir, el *DERECHO A LA PROSPERIDAD MEDIANTE EL TRABAJO*. Los mexicanos somos un pueblo trabajador, pero no existen oportunidades suficientes para todos aquellos que desean ejercer ese derecho en forma honrada y legal. Modificar lo necesario para corregir esa deficiencia del sistema económico, debera hacerse como PRIORIDAD NACIONAL.

(03) SALVAR EMPLEOS EXISTENTES: Lo primero que debemos hacer para ofrecer este gran numero de empleos que requerimos, es implantar un *PLAN DE SALVAMENTO* que evite el cierre innecesario de fuentes de trabajo, situacion que se está dando por deformaciones en nuestro mercado a consecuencia de la apertura indiscriminada de fronteras, un sistema financiero inadecuado, la reglamentación excesiva y una corrupción generalizada. EL PLAN DE SALVAMENTO debera dar todas las facilidades a las empresas en dificultades financieras y económicas, para que sigan trabajando por el bien de todo el pais. Treguas fiscales, laborales y créditos sobre impuestos, son algunas de las medidas que se pueden tomar. Para animar aún mas la creacion de empleos, sobre todo en empresas pequeñas y micro, que son las que generan más plazas de trabajo con menor inversion, se requiere implantar un plan decidido de *INCENTIVOS Y APOYOS A LA CREACIÓN DE EMPLEOS Y LIBERAR TODAS LAS FUERZAS PRODUCTIVAS DEL PAÍS.*

(04) CREACIÓN DE NUEVOS EMPLEOS: Para abrir una fuente de trabajo, se requiere invertir capital y espiritu empresarial, entre otros elementos. Las politicas equivocadas del pasado no han permitido la formacion de suficiente capital mexicano por lo que atraer capital y empresas extranjeras contribuiria a la creación de una pequeña parte de los empleos que requerimos, los demás deberán ser creados por nosotros con toda seriedad y energia aprovechando al máximo nuestros recursos y aquello que nos represente ventajas y soluciones.

(05) DEFENSA DE TRABAJOS MEDIANTE EL CONSUMO: Todos los que en este pais compramos algo y en forma especial, empresarios y gobierno deberíamos dar preferencia a proveedores, contratistas y productos de origen mexicano o con elto contenido de mano de obra mexicana. Una fuerte campaña de concientizacion en radio, prensa y television con el apoyo de todos los sectores es lo minimo que debemos hacer.

(06) DIFERENTES TIPOS DE EMPRESA: Con la certeza de que cualquier bien o servicio que se produzca en México, es hoy más que nunca, un ahorro para el pais y por lo tanto, una riqueza que permanece entre los mexicanos, proponemos diferenciar por lo menos tres tipos de organizaciones productivas.

(07) 1.- ORGANIZACIÓN PRODUCTIVA MÍNIMA Se conformará de pequeños inversionistas, artesanos, cooperativas, empresas de interés social, empresas familiares, rurales, etc., que no rebasen ciertos limites y cuyos requisitos contables, fiscales, laborales etc., sean minimos. Estas empresas seran una valvula de alivio para millones de familias y cumplirán un importante papel en capacitación, ocupación, producción y disminución de la actividad delictiva en nuestro pais. Inicio de actividades con solo declararlo.

(08) 2.- ORGANIZACIÓN PRODUCTIVA MEDIA: Estas empresas tendrán requisitos administrativos simplificados, tasas de impuestos bajas y prestaciones laborales básicas, asi como un ***Seguro Social Simplificado***. Podrán , si lo desean, aportar al SAR, INFONAVIT y similares. También podrán optar por acogerse a los beneficios del *PLAN DE SALVAMENTO* cuando asi lo requiera su supervivencia.

(09) 3.- ORGANIZACIÓN PRODUCTIVA MADURA Serán todas aquellas que, por sus volúmenes de operacion y alta inversion de capital por cada empleo creado, deben aportar mayores tasas de impuestos, salarios superiores, prestaciones sociales similares a la de los paises desarrollados y en general, condiciones de competencia internacional y abierta. Deberan *respetar los limites de **conducta en el mercado*** que los mexicanos les fijemos, de acuerdo a nuestra particular cultura y defensa de valores

ADUANAS Y FRONTERAS

(10) ELIMINAR EL CONTRABANDO: Esta plaga, que se origina por la voracidad de algunos malos empresarios y politicos, provoca graves efectos como, desempleo, competencia desleal, impuestos perdidos y cierre de empresas. Eliminarlo o cuando menos reducirlo a su minima expresión, no requiere más que voluntad politica, castigos ejemplares y la cooperacion de los buenos mexicanos

(11) PRACTICAS DESLEALES DE COMERCIO ("DUMPING"): Algunas industrias extranjeras y en casos extremos, paises completos con el apoyo de sus gobiernos, se dedican a vender abajo del costo o sin respetar derechos humanos, normas ecológicas minimas, etc. , con el fin de hacerse de divisas. Nuestro gobierno debe reaccionar con toda energia para evitar el comercio con esos paises y detener asi el daño que nos causan, ya que dejan sin oportunidad a nuestros empresarios y con ello se genera la pérdida de empleos de mexicanos

(12) PROTECCIONES Y SALVAGUARDAS DEL T.L.C.: Una vez determinadas las industrias o productos a los que México apostara su futuro, debemos usar todas las protecciones y medidas a nuestro alcance para lograr su crecimiento y desarrollo

(13) RECIPROCIDAD COMERCIAL ENTRE PAÍSES: Ningún pais puede, en forma sostenida comprar al exterior más de lo que vende sin empobrecerse hasta llegar a la crisis. Debemos exigir y dar un trato reciproco y balanceado a lo que compramos y vendemos a cada pais. El establecimiento de CUOTAS DE IMPORTACIÓN deberia ser usado para proteger nuestra economia. Mantener un tipo de cambio realista con protecciones contra especuladores es requisito indispensable para dejar de subsidiar a las importaciones y con ello las economias de otros paises

MANEJO DE LOS IMPUESTOS

(14) ¡TODOS DEBEMOS PAGAR IMPUESTOS!: Bajo un nuevo esquema simplificado y justo podemos y debemos acabar con los evasores fiscales. Proponemos eliminar los impuestos a las pequeñas empresas que reinviertan sus utilidades, convirtiéndolas asi en fuentes de ahorro y empleo.

(15) ¿ CUANTO DEBEMOS PAGAR ?: Lo primero que un pueblo debe decidir es la cantidad de impuestos que va a pagar, los cuales sin duda son indispensables para el buen funcionamiento de la sociedad. Si se pagan pocos impuestos, la sociedad y su infraestructura avanzarán a paso lento. Si se pagan muchos, el avance será rápido, pero con el riesgo de empobrecer al pueblo y meterlo en una *"jaula de oro"*. Para fijar antes que nada el importe total de los impuestos que deseamos aportar sin dañarnos, proponemos se realice una ***CONVENCIÓN DE CONTRIBUYENTES*** con la participación de expertos, diputados y senadores. Esto determinará a qué ritmo se invierte en la construcción y mantenimiento del pais.

(16) ADMINISTRACIÓN EFICIENTE DE LOS IMPUESTOS: Se debe adelgazar el aparato gubernamental, obtener la simplificación de leyes fiscales y administrativas, asi como optimizar la aplicacion de los recursos, evitando desviaciones, corrupción en la aplicación y gastos superfluos que ningún beneficio dejan.

(17) PRESUPUESTO DE INGRESOS Y EGRESOS: Es inaceptable un superavit en este renglon ya que los impuestos se cobran para ser gastados. El presupuesto deberia estar balanceado o si acaso, podria tener un pequeño deficit en el que los gastos no excedieran en mas del 2% a los ingresos.

(18) BORRÓN AL PASADO FISCAL: Una vez simplificados todos los sistemas y acordados los importes a pagar por los diversos causantes, deberá decretarse por única vez, una tregua que elimine el pasado fiscal y que permita poder exigir el cumplimiento minucioso, a partir de la nueva fecha. ***UN SISTEMA DISEÑADO ALREDEDOR DE LA CONFIANZA*** que deberia existir entre pueblo y gobierno, siempre funcionará mejor que aquel diseñado alrededor de los malos ciudadanos y malos empresarios. Proponemos que las auditorias a los pequeños y medianos causantes sean por sorteo público. Los grandes causantes deberan ser auditados en forma permanente

(19) COMO DEBEMOS PAGAR: Simplificar la forma de tributar y eliminar todos los impuestos que se han adicionado, provocará mayor recaudación asi como la eliminacion de grandes cargas de trabajo improductivas que tanto del lado del gobierno como del de los causantes, existen. Toda esta fuerza laboral altamente calificada que se liberara, podra dedicarse al trabajo realmente productivo

FINANCIEROS Y CREDITICIOS

(20) BAJAR EL COSTO DEL DINERO: El costo excesivo del dinero que estamos sufriendo todos los mexicanos no es solamente debido a la voracidad de los bancos y a la tardanza con la que se les está exponiendo a la competencia. Mas bien se debe al elevado costo-pais y a la carencia de capitales mexicanos, lo cual provoca que el gobierno, para financiar el deficit de divisas asi como la sobrevaluación del peso, se vea forzado a pagar altisimas tasas de interés al capital externo, causando que los mexicanos tengamos que pagar muy caro por el credito que requerimos. Bajar el costo-pais y dejar de pagar tan alto por el capital especulativo nos a poder crear mas empresas y trabajos

(21) CRÉDITO AUTOMÁTICO SOBRE IMPUESTOS POR PAGAR: Todas las empresas de la categoria "media", que se registren en un "Plan de Salvamento", deberán poder obtener crédito automatico sobre un minimo equivalente

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a los impuestos que deban enterar, en donde la tasa de interes debera ser igual a la que paga el gobierno, o sea la de los CETE. anterior operaria mediante la simple entrega de un documento pagadero a un año o mas, en lugar del cheque que deberia acompañar las declaraciones del causante

(22) SUSPENSIÓN DE PAGOS: La simplificación de los mecanismos para que una empresa se declare en suspensión de pagos, con objeto de evitar su cierre, puede salvar muchas empresas Esto seria el equivalente a la ley llamada "CAPITULO ONCE", que en los Estados Unidos de América ha salvado a muchas empresas que logran proteccion temporal de sus acreedores y evitan el cierre definitivo.

(23) RENEGOCIACION DE DEUDAS (MORATORIA CIVILIZADA): Bajo la maxima "*DEBO SI PAGO LO JUSTO EN CUANTO TENGA*", renegociar las deudas que las fuerzas productivas tienen con bancos y gobierno Aplicar la misma lógica para la deuda que tiene el pais y reanudar el crecimiento de la producción nacional, única posibilidad de pagar las deudas algún dia y mejorar el nivel de vida de los mexicanos

(24) ALTERNATIVAS PARA OBTENCIÓN DE CRÉDITO Y CAPITAL: Proponemos desregular la actividad bancaria y bursátil, buscando con esto un mayor numero de participantes y un acceso más sencillo para las pequeñas, medianas y micro empresas El ingreso a la Bolsa de Valores y la emisión de acciones, mediante la cual los inversionistas nacionales pueden participar en los requerimientos de capital y crédito de una empresa, sin la intermediación de los Bancos hasta ahora ha estado reservado sólo a las grandes empresas Abrir y simplificar dicho mecanismo a asociaciones de empresas nacionales uniones de crédito, empresas medias, cooperativas y similares, seria un gran alivio para las necesidades de credito de aquellas y alentaria a los ahorradores a ***convertirse en inversionistas de empresas***, en lugar de ser cuentahabientes de bancos

OTROS NO ECONÓMICOS

(25) DEMOCRACIA Y PARTICIPACIÓN POLÍTICA Alentar la participación de la sociedad mediante encuestas y referéndum. Impulsar la verdadera democracia, la cual no es solamente el conteo correcto de los votos sino una cultura permanente de ***verdad y calidad de información*** Para empezar con este proceso, se requiere que la sociedad tenga acceso a los medios masivos de información sin tener que depender de los intereses comerciales por lo que se solicita que la nueva ley de medios asigne frecuencias de radio y televisión para uso de la sociedad civil

(26) EDUCACIÓN Todo esfuerzo resultara estéril si no podemos educar a ***todos***, sobre todo a las nuevas generaciones Todo los gastos que realicen personas o empresas para mejorar la educación y capacitacion, deberan ser automáticamente deducibles de impuestos, incluyendo la educación de los hijos. Propiciar la multiplicación y mejoramiento de las instituciones educativas y de capacitación

(27) EDUCACIÓN FUERA DE LA ESCUELA Impulsar toda aquella educación que se pueda dar utilizando otros medios que no son las escuelas y cuyo potencial mayor se encuentra en los medios de informacion como televisión y radio. La sociedad mexicana y su gobierno deberlan de ver que cumplan con esta importante funcion que puede dar resultados inmediatos en contraposición de la educación formal que requiere más tiempo para dar sus frutos

(28) RESERVA MORAL Mucho se ha hablado de la reserva moral que la sociedad mexicana representa y sin embargo notamos que sin limite aparente, se intenta transformar la moral y los buenos valores mexicanos, permitiendo que la lógica comercial opere como único mecanismo en los medios de comunicación, sobre todo en la television comercial El mercado y la libertad tienen limites, y claramente uno de ellos deberá ser el bienestar, la educación en la preservacion de la sociedad y sus valores Prohibir la publicidad de productos nocivos para la salud y limitar los programas producidos en el extranjero y los de valores claramente negativos

(29) TRABAJADORES MIGRATORIOS Aceptando la pena que significa que no podamos aun proporcionar empleo digno a todos los mexicanos en su propio pals, deberemos defender decididamente y por todos los medios a nuestro alcance, la dignidad, la justicia, y respeto a los derechos humanos de los mexicanos que se encuentran trabajando en otros palses, sobre todo cuando esos palses reciben grandes beneficios de esta mano de obra barata asi como mantienen relaciones comerciales con México que le son y le han sido favorables a lo largo de la historia

El "FORO DE CAMBIO EMPRESARIAL", invita a quienes coincidan en la generalidad de los anteriores planteamientos a difundirlos por todos los medios a su alcance También a manifestar abiertamente sus sugerencias para un México mejor, en el foro nacional que para ese proposito estamos organizando con la ayuda de todos los que puedan sumarse como parte de una ***NUEVA ACTITUD*** participativa, propositiva y saludablemente critica Agradeceremos enviarnos sus opiniones y sugerencias a FORO DE CAMBIO EMPRESARIAL / Fax (91 22) 49 55 88
BARZ2 WPS

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R E S U M E

Gabriel Hinojosa Rivero
Age 46
Married to Elizabeth Brigham (St. Cloud, Minnesota)
Daughter Ana (17), Carlos (14)

STUDIES 4 years of engineering at the University of the Americas

WORK:
- Production Manager (4 years) Refrigeration equipment factory
- Administrative Manager (2 years) Enamel Cookware Factory
- Administrative Manager (2 years) Washing Machine Factory
- Owner and President (16 years) Personal Computers dealership

SOCIAL: In the last five years I have been active in my neighborhood, and president (759 families) for 3 years. Advisor for the local Chamber of Industry (CANACINTRA), Credit Union, Social Union of Businessmen (USEM) and actually on the board of directors of COPARMEX, a volunteer union of business. Initiator and first President of "FORO DE CAMBIO EMPRESARIAL", and analysis group to give and take information from business people and social leaders.

BUSINESS ADDRESS: Abaco Computadoras Para Negocios, S.A. de C.V.
Reforma 3104
Puebla, Pue.
MEXICO
Phone (22) 48.9711 Fax: (22) 49.5588

BUSINESSMEN FORUM FOR CHANGE - CONSTITUTION

OBJECTIVE: The objective of this group is to establish a forum for small businessmen, that would permit its members to obtain quality information in order to make correct decisions, likewise to serve as a recipient of ideas and opinions of businessmen in order to transmit them to leaders in different sectors of society, promoting and defending the real spirit of the businessman.

PHILOSOPHY: Although this is an open, non-party affiliated group that accepts all beliefs, its important to have a solid value structure to avoid differences in the future These values are those expressed in the Christian Social Doctrine and in the declaration of human rights of the United Nations. Additionally, we will always place the interest of Mexico over those of smaller groups.

DENOMINATION: The name of this organism is "Foro de Cambio Empresarial" and its theme is a "Small businesses are the grand solution".

Industrias Victoria de Puebla S.A. de C.V.

Kilometro 5 ½ Carretera Puebla-Atlixco Puebla, Pue México Tel 54-01-10 Fax 54-02-14

MAY 22nd 1995

THE SENATE BANKING COMMITTEE
U.S. SENATE
WASHINGTON D.C.
USA

ATTENTION SENATOR ALFONSO D'AMATO

DEAR SENATOR:

OUR COMPANY WOULD LIKE TO EXPRESS BY WRITING OUR OPINION ABOUT THE WAY THE MEXICAN GOVERNMENT HAS BEEN HANDLING THE ECONOMIC CRISIS.

WE DO NOT AGREE TO A NEGATIVE GROWTH RATE OF MINUS 5% ON OUR GNP. WE FEEL THE CENTRAL BANK SHOULD USE PART OF THE RESOURCES OBTAINED IN THE UNITED STATES AND IN THE WORLD (A GRAN TOTAL OF 58 BILLION DLLS) TO RE-ACTIVATE OUR ECONOMY.

MANY JOBS ARE BEING LOST THOUSAND OF COMPANIES WILL DISAPPEAR AND WE FEEL THIS IS A VERY HIGH PRICE TO PAY FOR MISS-MANAGING OUR ECONOMY DURING THE LAST SIX YEARS OF AN EXCESSIVE OPENNING OF OUR BORDERS TO THE RE. OF THE WORLD.

THIS COMPANY HAS HAD TO DECREASE IS PRODUCTION RATE BY 60% AND HAS HAD TO SEND MORE THAN HALF ITS WORK FORCE HOME FOR THE LAST THREE MONTHS. IF THE CRISIS CONTINUES ANOTHER SIXTY DAYS WITH THE INTESITY THAT HAS BEEN GATHERING WE WILL HAVE TO CLOSE THE PLANT.

OUR DEBTS WITH BANKS SUPPLIERS AND CREDIT UNI-ONS ARE NOW ALMOST EQUIVALENT TO THE NET WORTH OF OUR BUSINESS AND WE CANNOT CONTINUE TO OPERATE ON THIS TYPE OF ECONOMIC ENVIROMENT. THIS OF COURSE AFFECTS MANY OTHER BUSINESS. ALL "PAYMENT CHAINS" IN THE COUNTRY HAVE BEEN BROKEN

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Industrias Victoria de Puebla S.A. de C.V.

Kilometro 5 ½ Carretera Puebla-Atlixco Puebla, Pue. Mexico Tel 54-01-16 Fax 54-02-14

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AND OUR OWN CUSTOMERS BECAUSE THEY CANNOT PAY US ARE PRACTICALLY PUTT US OUT OF BUSINESS AND WE OURSELVES MUST BE DOING THE SAME WITH SOME OUR SUPPLIERS ETC.

WE FEEL THAT THE NEW OPTION FOR MEXICO AS A COUNTRY SHOULD BE AN ECO MODEL THAT WOULD RE-ASSIGN RESORUCES SO THAT AT LEAST WE COULD TARGE FOR A GROWTH RATE OF 1% THIS YEAR EVEN IF WE HAVE TO INFLATE THE ECO OR MAKE WAIT THE INVESTORS OF WALL STREET AND OTHER PARTS OF THE WOR THE NEO-LIBERAL MODEL IS AT STAKE. IT CANNOT MAKE PROGRESS ON THE B BONES OF ALL THE INDUSTRIAL AND AGRICULTURAL BUSINESS OF MEXICO. AI MANY SMALL SHOPS (COMMERCE) IS SUFFERING GREATLY AND MANY SUCH BUSINESS ARE CLOSING DOWN. WE CANNOT WORK WITH SUCH A POOR "AGGREG. DEMAND" IN THE WHOLE ECONOMY.

THE UNITED STATES SHOULD SEE THAT YOUR RESORUCES SHOULD BE CHANNELE CHAMBERS OF INDUSTRY AND COMMERCE AND AGRICULTURE IN MEXICO BEFOR TOO LATE. MANY RISKS ARE BEING TAKEN THROUGH THIS SEVERE ADJUSTMEN PROCESS AND WE FEEL ANYTHING COULD HAPPEN THAT WOULD RISK THE SOCIA AND POLITICAL STABILITY OF THIS COUNTRY.

MANY MORE THINGS COULD BE SAID. AS BUSINESS MEN THAT WORK VERY HA KEEP BUSINESS ALIFE WE FEEL THAT AN EVENTUAL CHANGE IN GOVERNMENT BE THE ONLY REAL SOLUTION FOR MEXICO.

YOURS TRULY.

RICARDO VILLA ESCALERA

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Puebla, Pue., a 22 de Mayo de 1995.

A QUIEN CORRESPONDA:

Sres:
Nos da algo de esperanza el saber que se interesan en conocer la problemática económica que estamos viviendo en la INDUSTRIA MEXICANA, sobre todo en la pequeña-empresa, que es mas grave de lo que se puede alcanzar a ver.

Somos una empresa 100% mexicana fundada en el año de 1960 por Manuel Arriaga Maceda, nuestro giro es el diseño, fabricación y comercialización de bombas para agua uso doméstico, aplicables a pequeños riegos y a la industria, hemos sido líderes nacionales y exportadores.

Con certeza afirmamos que la apertura comercial desde inicios del GATT fue descriminatoria para la industria Mexicana, pues estábamos sin bases para competir en un mercado global y CON DESVENTAJAS DOLOROSISIMAS E INJUSTIFICALBLES EN LAS TASAS DE INTERES USURERAS IMPUESTAS POR LA BANCA MEXICANA, esto fue la principal causa de la descapitalización de las empresas.

Al Gobierno mexicano en repetidas ocasiones los empresarios manifestamos nuestra inconformidad, pero el expresidente salinas nunca escuchó, y siempre se vió protector de la USURA DE LA BANCA.

Como resultado de la política económica de carlos salinas de gortari (lo escribimos con minúscula por concierarlo un mal presidente, ya que nunca supo responder al hambre y al dolor de su pueblo, al que engañó). El Dr. Zedillo lleva el mismo sistema y a eso tenemos nuestra planta al 10% de su capacidad productiva, con fuertes problemas de liquides, además por escuchar sus mentiras y falsas promesas de crecimiento económico, y con nuestro afán de trabajo y de seguir siempre adelante hipotecamos nuestra casa, el inmueble de la fábrica y lo estamos perdiendo todo, por como está la desaceleración económica, el desempleo que hoy alcanza porcentajes elevádisimos, las tasas de interes impagables, no hay en estas condiciones fábrica que pueda pagar sus pasivos a los bancos. En nuestro caso son 35 años de trabajos multiplicadps por horas hombre son MILES DE HORAS DE TRABAJO PERDIDAS E INRRECUPERABLES.

Los mexicanos sentimos ya que no podemos permitir perder nuestro patrimonios que están en juego, los cuales hicimos a travez de muchos años, de lucha trabajo y sacrificios, y ahora por 2 años de crisis gravísima en nuestro país lo estamos perdiendo todo, siendo embargados nuestros bienes por la BANCA USURERA , que quiere hacer pactos fuera de la Justicia y de la Ley, que presiona al deudor tratándolo como delincuente demandándoles y girando arrestos y además nos llama morosos.¿SEÑORES USTEDES PERMITEN SER TRATADOS ASI? más cuando nosotros no fuimos los causantes de la crisis sino la MALA POLITICA ECONOMICA ADOPTADA POR NUESTRO GOBIERNO SALINISTA.

MILLONES DE MEXICANOS NOS ENCONTRAMOS ANGUSTIADOS, DESESPERADOS Y SIN ENCONTRAR RESPUESTA POSITIVA DE NUESTRO GOBIERNO Y SIN ENCONTRAR CAMINOS QUE NOS INDIQUEN HACIA DONDE VAMOS.

Esperamos que nuestros comentarios le sirvan para darse cuenta de la realidad que se VIVE EN MEXICO, el callar lo que vivimos es no tener dignidad ni valores.

ESPERANZA SANCHEZ DE ARRIAGA

G E I S E R D E P U E B L A, S. A. D E C. V.
BUGAMBILIAS 5945 COL BUGAMBILIAS TEL 45 79 10 FAX 45 79 11
72580 PUEBLA, PUE. BOMBAS PARA AGUA

PREPARED STATEMENT OF LILIANA FLORES

FORMER MEMBER OF THE MEXICAN CONGRESS, NATIONAL EXECUTIVE COMMITTEE, MEMBER OF "EL BARZON," MONTERREY, MEXICO

MAY 24, 1995

Gentle members of the audience, my name is Liliana Flores Benavides. I am 40 years old, an economist, and a social activist. I have participated in several citizen movements, such as the ecology issue throughout the Mexican-American border, the defense of the political and human rights of the Mexican citizens that live abroad, and at present I am struggling in favor of the economic and social rights of the Mexicans that, like me, are victims of the uncontrollable failure of the neoliberal model in my country, using, as a means of struggle, El Barzon organization, and, as a member of its National Coordinator, I am here to represent it.

El Barzon is a national organization that was born in Mexico 2 years ago. It agglutinates Mexicans of the small and medium productive sectors of the country which are the expression of the Mexican middle class. It is an organization that was basically founded by farmers and cattlemen but, today, it is also formed by businessmen, traders, service lenders, *college-educated people*, and employees, all united with these problems: *past-due credit*, lack of *liquidity* and profitability of their productive units, and decapitalization. Politically and ideologically, it is a plural and democratic organization and is here to break the traditional organizational schemes in Mexico. At present there are more than 1 million affiliates.

Those who claim that the Mexican crisis started with the devaluation of December 1994 are absolutely wrong. The instrumentation of the neoliberal model in Mexico which started during the Administration of Miguel de la Madrid and the profoundness of the adjustment program that the *International Monetary Fund* demanded during the Salinas de Gortari Administration accumulated a great social cost that was translated into a social debt that different sectors of the Mexican population are demanding must be paid. The demand gets even greater after a great ideological fraud that Salinas de Gortari made to the nation and to foreign countries, making them believe that my country was the vivid expression of the success of this neoliberal model, up to the point where we were changing from a Third World country into a First World one. This was a great lie for everybody.

While all the Mexicans were soaking in a speech that told us about a fiction economy, the reality of millions of citizens was different. The decay in the quality of life was tremendous. The crisis that is produced after the peso devaluation was existent in the Mexican rural areas 2 years ago. The expensiveness of money in Mexico and the irrational openness of the border made the entrance of farm products (grains and meat) possible at prices even lower than the cost that the national producers had in producing them. While the annual interest rates in the United States varied between 5 and 6 percent and in Europe between 2 and 4 percent, in Mexico it was between 18 and 25 percent. This began to generate a bottleneck in the farms since the farmers could not sell their products, and, as a result, could not pay their debts to the banks. These institutions began to seize the properties of farmers and cattlemen, and, as a consequence of this situation, El Barzon was born.

After an analysis of the economic situation we noticed the results of the neoliberal model and of how far the speech of Salinas was from reality. With official figures, which we know are made up, this economic policy has left, on one side, 40 million poor and, on the other side, 24 multimillionaires in dollars according to the Forbes list. Neither of the sides has the problem of *past-due credit* since the poor do not have enough economic warranties that can entitle them to credit and, on the other hand, the multimillionaires do not need credit since they are the owners of the money in this country; therefore the problems of *past-due credit* is within the hands of us, the Mexican middle class, since we need credit to own a house, to develop a business, or to buy a car.

Why was it that this middle class, that offers up to 90 percent of employment in some productive sectors, could not pay? Because there was no *liquidity*, and a total decapitalization; this middle class, due to the apologetic speech of Salinas that painted a lovely scenery, indebted in the hope that there would be a better future. Today millions of Mexicans are in real danger of losing their family patrimony, which is the result of the effort of many years of work, because the banking institutions charge usurious interest rates. When we noticed this, we decided to form a national organization and since it was a problem of economic policy, this was the only way of making a counterbalance.

After the devaluation in December 1994, the problem of the *past-due credit* became more serious. The irrational increase of the interest rates, up to 130 percent annually, and the application of the shock program have made this economic prob-

lem to turn out as a national social problem. The terrible decay in the quality of life has caused a great weakness in the Mexican family. The uncertainty of losing, or not being able to pay for the family patrimony, has caused a great number of suicides (we have counted 451), an increase in heart and nerve diseases, divorces, and problems with the children. What else could we expect if in 1994 there were 10,000 properties adjudged in the rural areas, or now in 1995 more families have lost their houses to the banks than those who lost theirs during the 1985 earthquake?

The neoliberal shock program is a mistake since it is here deepening the economical problems rather than relieving them. We consider that it will not only provoke a recession but also an economical depression. The fact that for an executive decision the Clinton Administration authorized a credit line for $20 billion so that passives are to be paid in a short-term is a great mistake. It is exactly the same logic of the owners of money in Mexico: "I'll lend you so you can pay me, but I need warranties." In this case, the warranties were the future sales of the oil. In the economic and social context, it would have been very important to renegotiate at a medium- and long-term some part of the short-term debt, and a part of that credit line would enter as fresh money to the economic flow of the country, since there is no money to work.

Somebody might ask, "Why does the United States have to help Mexico in such a way?" Simply because the demands that the International Monetary Fund and you make to the Mexican government can also hit the American country as a boomerang. You cannot keep us from being your neighbors and we will always be. As an example, it's enough to say that the NAFTA is a "dead letter." Let's remember the main argument of those who defended it. They said that if it was approved, the door to the largest potential market of Latin America would be opened. The issue is that the potential market, the Mexican medium class, can't buy anything since we are at present at subsistence levels and, while we don't have any money to work, we will continue in the same situation. This automatically will translate in a loss of jobs for the North American people. Also, we mustn't forget that we are a sector that supplies more jobs in the country, and that if we are affected economically, the ghost of the lack of jobs will be in the streets of my country. And you that have made the migration problem an issue of political debate, inclusively for the next Presidential elections, regardless of the walls, police, and fees you charge, you will still have millions of economic refugees in the border with Mexico. This problem will be prevented by generating jobs in the Mexican cities and preserving the existing jobs.

Finally, I mention the worsening of our situation due to weather conditions of dryness in the northern states of the country, an issue that has produced a collapse in the cattle and farming sector, so bad that it has reached the point of having to ask your country for water with the purpose of saving the least, and it worries us your refusal to this petition. Independently of humanitary motives, is this the way a commercial partner is treated?

A recessive shock plan, an usurious financial policy, the drought that is affecting the northern states of Mexico, and the closure of spaces where we can make our opinion be heard, that is our daily life. We Mexicans saw with great impotence, as an obscene sign from the PRI leader of the Mexican Congress, the approval of the IVA increase. The annual amount of what will be recollected is equal to the gross income that Carlos Slim receives in 5½ operation days in his companies. Is this a fair neoliberal economic policy?

You mustn't forget that the Mexican people don't notify, they simply act. We, with our movement, have decided to fight within the limits of the law, making of the rights, a culture. We have decided to pick up our ran-over dignity and fight for our family, our patrimony, and for our country. With the law in the hand and the pacific but active civil resistance, we will continue to impulse this movement of consciousness in our dear Mexico.

PREPARED STATEMENT OF DR. JOHN A. AUPING

PROFESSOR OF MACROECONOMICS, IBERO-AMERICAN UNIVERSITY AND AUTONOMOUS TECHNOLOGICAL INSTITUTE OF MEXICO, MEXICO CITY, MEXICO

MAY 24, 1995

The Impact of the Devaluation on the Mexican Banking System

The crisis is not just one of exchange rate instability, but of virtual bankruptcy of Mexican banks and companies. The problem started *before* the December 1994

devaluation. When the government sold the commercial banks that it had nationalized in 1982 back to private owners in 1991 and 1992, it charged double the price that the banks' assets really were worth. It sold the banks at $13 billion when their actual value was $6.5 billion. The government and the new owners that bought them had a silent agreement that the government would give the new owners time to make society pay their expensive investment. The new owners increased the differential between the interest rate on savings and the one on loans to usurious heights, that is, about 10 percent to 20 percent in 1993, when nominal interest rates were 25 percent to 36 percent, varying according to the amount of the loan. The government and the new owners also convened that the banks would be protected against foreign competition for 15 years (as one can verify in the NAFTA). This financial protectionism resulted in a high degree of inefficiency of the banks, as compared with the United States.

This combination of usurious interest rates on loans and a severe degree of inefficiency is the cause of the rapidly increasing amount of notes due by the economy in general and the manufacturing sector in particular. The amount of notes due in real terms increased by 60 percent in 1993 and by 80 percent in 1994 *before* the December crisis. So the crisis that erupted with the December 1994 devaluation did not create the problem of usurious interest rates, but it certainly did aggravate the problem. The differential between interest rates on savings and on loans now varies from about 10 percent to 45 percent. Since annual inflation in 1995 will be about 52 percent, and interest rates on credit cards vary from 80 percent to 110 percent, the real interest rates on these credits vary from 18.4 percent to 38.2 percent! Nominal interest rates on savings vary from 18 percent to 40 percent, so real interest rates on savings are negative varying from −23 percent to −8 percent. While banks rob debtors by means of usurious interest rates, they rob people and companies that save with negative interest rates, decapitalizing them. *After* the outburst of the crisis the amount of notes due in real terms increased by another 30 percent in 3 months. At the end of April 1995, the total amount of notes due on business loans was N$76.000 millions; on mortgages, N$31.000 millions; on states' debts, N$15.000 millions; and on dollars loans, US$5.900 millions. The total amount of notes due is N$157.400 millions.

Government has tried to ease the problem by introducing the so called UDI's (Investment Units) that keep debts constant in real terms and make debtors "only" pay real interest rates. This solution postpones but does not prevent bankruptcy, making it even worse when it arrives. This is why companies and families with debts prefer other solutions, associating themselves in organizations like "El Barzon," "Frente por la Defensa del Patrimonio Familiar," the "Coordinadora Nacional de Usuarios de la Banca," and the "Asociacion Nacional de Tarjetahabientes" to collectively defend themselves against usury, which is forbidden by Mexican law. Even smaller towns now have offices of "El Barzon" and banks face big problems making people pay.

The majority of companies with notes due and of people whose properties are mortgaged will keep on being unable to pay what they owe, so banks won't get their money back. At the same time there will be a massive problem of decreasing savings, since people lose their jobs and withdraw their savings in order to consume them. At the same time big companies and rich families keep their savings in the United States. So banks will be short of cash anyhow. Given the fact that the banks obtained government bonds for the notes-due-documents (through the mediation of a trust fund), banks having cash flow problems will put pressure on government to let them collect pesos for their bonds. Should the government yield to this pressure that would mean hyperinflation. Should it not yield as is probable, then the banks have two options: to be bought and rescued by the Mexican government, as has already happened with Banco Cremi and Banco Union, starting a subtle process of nationalization of the banking system, or to be bought and rescued by United States banks.

The Impact of the Adjustment Program on the Mexican Economy

The Administrations of the United States and Mexico agreed to a voluminous assistance package to rescue Tesobono holders that wanted to collect dollars for their bonds. To this loan guarantee IMF-inspired conditions were attached that decrease the real amount of money in the economy by −20 percent and the internal demand by at least −10 percent. This will provoke a recession of −5 percent of the GDP, together with an increase of interest rates that were already usurious before the crisis and are now even more so.

Sales in different branches of industry decreased in the first quarter of 1995 by a minimum of 30 percent to a maximum of 100 percent. In that same quarter, a sample of 180 big companies that issue stocks in the Mexican Stock Exchange have

not been able to collect money for their sales for a total amount of N$50.880 millions, that is, 53 percent of their total first-quarter income.

Employment in the formal sector will diminish by at least 1 million in 1995, which will bring the Mexican economy to the same level of employment in the formal sector as existed in 1981, that is, 22 million people. Since the labor force has been growing by 3.5 percent a year in the same 14 year period, the rate of unemployment together with the rate of employment in the informal sector will reach, in 1995, a 41.5 percent rate.

A Harvard economist, Mankinw, in his book on macroeconomics, states that few economists today would recommend, in the face of massive unemployment, the measures applied by the U.S. Government in 1929 at the beginning of the Great Depression. But the Zedillo Administration applies more severe reductions of the real amount of money in the economy, together with similar reductions of internal demand, in the face of more massive unemployment.

The government does not deny that it's adjustment program will provoke a severe recession but it states that it is the inevitable price to pay for the recovery of financial stability. This idea is wrong for two reasons. First, the adjustment program will most probably not achieve exchange rate and monetary stability, and, second, the recession will not pass by but transform itself into a depression that will last years, provoking uncontrollable social unrest and intents of migration to the United States of millions of illegal immigrants.

Economic Theory Behind the Adjustment Program is Alien to Reality

Besides ignoring the depression it provokes, the theory behind the adjustment program is simplistic as far as stabilization is concerned. The Administration explicitly states that, first, exchange rate stability depends on monetary stability and, second, that monetary stability can be achieved by reducing the real amount of money in the economy (even though the nominal amount will increase by about 20 percent). This theory does not stand the confrontation with reality. In fact, exchange rate stability does not only depend on monetary stability, but also on the relation between the demand and supply of dollars. And inflation feeds not only on monetary expansion (which explains 40 percent of the inflation rate), but also on devaluation (about 20 percent) and inertia or inflationary expectations (another 40 percent). For example, in 1995, inflation will at least be 50 percent [=.4*(20%)+.2*(100%)+.4*(55%)].

Interaction between inflation and devaluation in Mexico has a typical, 6-year pattern. For some years loose monetary policies create inflation rates that surpass devaluation, accumulating pressure on the pegged exchange rate. When people bet that the overvalued peso will lead to devaluation capital flight provokes a macro-devaluation that surpasses the devaluation that would have sufficed to neutralize overvaluation. Demand of dollars will push the devaluation to the point where a severe undervaluation of the peso is established. Undervaluation of the peso makes prices of imported goods much higher than national prices, provoking a 2 or 3 digit inflation. So, again for several years inflation will be higher than devaluation and new pressure builds up against the peso, preparing the next macro-devaluation. The next table shows this 6-year pattern:

Interaction Between Inflation and Devaluation In Mexico

*Cycle:**	*Accumulated internal inflation*	*Accumulated inflation-differential*	*Accumulated devaluation*
First cycle:			
Infl. > deval. 1970–75	78%	31%	0%
Deval. > infl. 1976	27%	21%	60%
Second cycle:			
Infl. > deval. 1977–81	183%	77%	32%
Deval. > infl. 1982	99%	87%	466%
Third cycle:			
Infl. > deval. 1983–84	188%	168%	42%
Deval. > infl. 1985–87	775%	698%	961%
Fourth cycle:			
Infl. > deval. 1988–93	241%	167%	41%
Deval. > infl. 1994–95	63%	54%	100%

* Infl. > deval. = inflation rate is higher than devaluation.
Deval. > infl. = devaluation rate is higher than inflation.
** Differential = differential between Mexican and U.S. inflation.

Right now, Mexico is entering its fifth cycle. If the Administration follows the well-known pattern, it will impose a pegged exchange rate in the second half of 1995. After the macro-devaluation of December 1994–1995, inflation will then be much higher than devaluation for some years to come, building up pressure on the pegged exchange rate until it breaks down again. The present euphoria about the apparent stabilization of the exchange rate, ignores that since April the variation of the real exchange rate has been negative which is an essential part of the very 6-year pattern just explained.

A Possible Solution to These Problems

The solution to these problems has two phases. In the first period of 4 months the Mexican financial system must be opened up to the immediate and full participation of U.S. banks, together with constitutional guarantees, given by Mexican Congress, that the dollar may circulate as a second currency in the Mexican economy and that dollar deposits cannot be confiscated by government as they were in 1982. This means that people may have peso or dollar savings accounts, as they wish, and that banks may give loans in pesos or dollars, as people wish. This means that a monetary multiplier is applied to the physical dollar reserve, as big as 1/s where "s" is the dollar reserve rate (the proportion of dollars commercial banks must keep as reserves). For example, with a dollar reserve of 8 billion and with a dollar reserve rate of s = 33 percent, the supply of dollars in the economy would be (1/.33)*8 = $24 billion. By having the dollar reserve multiplied by such a normal monetary multiplier that operates when people can do business with the reserve currency, the supply of dollars will be several times the amount of dollar reserves. The supply would then be big enough to meet the demand and that would really stabilize the exchange rate.

At the same time the use of the dollar in the economy would bring down interest rates, approaching them to the U.S. levels. Actually big companies and rich families already take advantage of these circumstances. Those that have debts outstanding with Mexican banks take dollar loans in the United States, pay their debts in Mexico, and then pay moderate U.S.-level interest on their dollar debts. And big companies and rich families that have savings or capital keep their money in the United States so as to protect themselves against another devaluation.

So my proposal takes into account what is already happening on a big scale, but with two differences: First, not only the big companies and the rich families would have access to dollar accounts and dollar loans, but also middle-class families and small companies. And second, since dollar savings and dollar loans would take place *in Mexico*, a process of monetary multiplication would increase the supply of dollars in the Mexican economy to several times the value of its actual dollar reserves, putting an end to the present problems of cash and liquidity without causing inflation.

After 3 or 4 months of opening up the economy to the use of the dollar, the exchange rate will be fixed at its actual market value and a Monetary Council will be put into place. This Monetary Council will have a representative of the IMF and of the U.S. Administration and a majority of Mexican councilors, most of whom will be elected by civil society. By law, the Council will be independent of government so as to guarantee that the Monetary Peso Base is being backed up by an equivalent Dollar Reserve. Free convertibility will exist, just as is now the case in Argentina. Argentina has not devaluated, neither before nor after its May elections, and its inflation is 3 to 4 percent. It is now ready to stimulate job creation by public and private investment and making the labor market less rigid. The same could and should be done in Mexico, after this monetary system has been installed.

April 19, 1995

SUMMARY

This is a summary of the "Diagnosis of the actual crisis and its possible solution" (35 pages, 1 appendix of 2 pages and 23 graphs), that analyzes the medium and short term causes and effects of the Mexican financial, economic and social crisis that was revealed and aggravated by the devaluation of December 1994. The references in this summary are to the graphs and tables of the essay.

Sometimes people comment that the Mexican crisis is one of exchange rate instability, erupting in December 1994, caused by expiring short term dollar-indexed bonds ("Tesobonos") and that the official adjustment program, agreed on by the Mexican government and the US Treasury Department in February 1995, will cause serious problems in the next three or four months to come, but will then yield the positive fruits of monetary and exchange rate stabilization. The essay analyzes the economic theory behind the adjustment program and shows it to be simplistic and partially wrong, and that, for that very reason, the program will not yield the fruit of stabilization, even though it pretends so. It then shows that there is a solution that implies less pain for both Mexico and the USA and that will yield lasting monetary and exchange rate stability in less than one year.

The crisis is not just one of exchange rate instability, but of a virtual bankruptcy of the Mexican economy. The problem started before the December 1994 devaluation. When the government sold the commercial banks, that it had nationalized in 1982, back to private owners in 1991 and 1992, it charged double the price that the banks' assets really were worth (see table 1 of the Appendix). It sold the banks for 13 thousand million dollars when their actual value was 6.5 T.M.D. The government and the new owners that bought them had a silent agreement that the government would give the new owners time to make society pay their expensive investment. The new owners increased the differential between the interest rate on savings and the one on loans to usurious heights, that is about 10 to 20 percentage points of total rates, in 1993, of 25% to 36%, varying according to the amount of the loan (see table 2 of the appendix). The government and the new owners also convened that the banks would be protected against foreign competition for 15 years (as one can verify in the NAFTA). This financial protectionism resulted in a high degree of inefficiency of the banks, as is revealed by a comparison with North American banks (see table 3 of the appendix). This combination of usurious interest rates on loans and a severe degree of inefficiency is the cause of the rapidly increasing amount of notes due by the economy in general and the manufacturing sector in particular (see graphs 1A and 1B). The real amount of notes due increased by 60% in 1993 and by 80% in 1994, BEFORE the December crisis. After the outburst of the crisis it increased by another 30% in three months. The enormous amount of notes due has brought both the productive and financial sector to virtual bankruptcy. The devaluation did not cause that problem, though it certainly aggravated it.

The devaluation itself was caused by some mistakes made by the government during the year 1994. In January or March 1994, it could have adjusted the slip of the pegged exchange rate,

preventing the disastrous devaluation. But the Salinas government wanted to prove that it was the world champion of monetary and exchange rate stabilization, so it did not adjust the exchange rate in time, thereby provoking the very devaluation it wanted to prevent. Additionally, it invited foreign investors to exchange their government bonds -that were not protected against the risk of devaluation- for "Tesobonos" that did protect against that risk. "Tesobonos", as a proportion of total governmental internal debt, went up from 10% to 72%, during 1994 (graph 6), with 80% in foreign investors' hands (graph 7). If the foreign investors would change their short term Tesobonos for dollars, that would deplete Mexican dollar reserves. If the Tesobonos-holders would demand pesos for their bonds, and a 100% devaluation would occur, the investors' utility would be triple: 1) a 100% utility because of the devaluation;
2) the utility derived from the interest rate on Tesobonos; and 3) the interest rate on Cetes bought with the pesos obtained by selling the Tesobonos (see graph 8B), right now with an interest rate of 80% on an annual base. Inviting foreign investors to exchange their Cetes for Tesobonos clearly was an invitation to provoke a more severe devaluation than the one that in itself had been inevitable because of the 25% overvaluation of the peso. Devaluation became a very profitable affair for Tesobonos-holders. This explains the December devaluation.

The governments of Mexico and the USA agreed on a rather voluminous loan guarantee to protect foreign investors that preferred to withdraw from the Mexican financial market. To this guarantee, IMF inspired conditions were attached that decrease the real amount of money in the economy by -20% and the internal demand by at least -10%. In macroeconomic terms this will provoke a recession of -5% of the Gross Domestic Product, together with an increase of interest rates that have reached, in April 1995, heights of 80% to 120% (graphs 3 and 15B), and an inflation that, according to the government will be 42%, but will actually come close to 60% in 1995. Sales in different branches of industry decreased in the first quarter of 1995 by a minimum of 30% to a maximum of 100% (maximum) (graph 15A). Employment in the formal sector will diminish by one million employees in 1995, that will bring the Mexican economy to the same level of employment in the formal sector as existed in 1981, that is 22 million people (graphs 2A and 2B). Since the labor force has been growing by 3.5% a year in this 15 year period, the rate of unemployment together with the rate of employment in the informal sector will reach, in 1995, a 41.5% rate and, in 1996, almost 50%. A Harvard economist, Mankiw, in his book on Macroeconomics, states that few economists today would recommend, in the face of massive unemployment, the measures applied by the USA government in 1929 at the beginning of the Great Depression. In fact the Mexican government applies more severe reductions of the real amount of money in the economy, together with similar reductions of internal demand, in the face of more massive un- and underemployment rates.

The government does not deny that it's adjustment program will provoke a severe recession but it states that it is the inevitable price to pay for the recovery of financial stability. This idea is wrong for two reasons. First, the adjustment program will most probably neither achieve monetary nor exchange rate stability and, second, the recession will not pass by but transform itself into a depression that will last years, provoking uncontrollable social unrest and intents of migration to the USA of millions of "braceros".

Why will the adjustment program not achieve stability? This is because the theory behind the program is deficient, so as to kill the program's efficiency. In presenting it's adjustment program, the government explicitly states it's theory that, first, exchange rate stability depends on monetary stability and, second, that monetary stability can be achieved by reducing the real amount of money in the economy. This theory does not stand the confrontation with reality, as we shall now see.

The idea that exchange rate stability depends primarily on monetary stability is simplistic. Its is rather the other way around. Monetary stability depends by about 20% on exchange rate stability, and exchange rate stability depends primarily on the relationship between the demand and supply of dollars. If demand surpasses supply, devaluation will bypass the differential of external and internal inflation rates by tens of percentage points. The very devaluation of December to April proves this point. According to the differential of external (USA) and internal (Mexican) inflation rates, a 25% devaluation would have sufficed. In fact it reached 100% in three months, because of the pressure of demand, inspired by distrust of the government's ability to achieve stability. Even though the exchange rate went down one peso/dollar in April, it will revert in the second half of this year because of the same pressure of the demand for dollars, to reach 8 to 9 pesos/dollar at the end of 1995, which means a 150% devaluation from December 1994 to December 1995 (graphs 14A and 14B).

This devaluation rate will result in an inflation rate of almost 60% in 1995. From 1970 to 1995, inflation in Mexico has been generated by three causes: 20% of it by devaluation; 40% of it by inertial inflation (caused by inflationary expectations); and 40% of it by the variation of money (M1) (graph 13). Since government admits for a nominal increase of money of 20%, and people expect inflation to be about 55% and devaluation will be 150%, the inflation rate will most probably amount to $(.2*(150\%)+.4*(55\%)+.4*(20\%))=60\%$. That will be the beginning of a vicious circle of inflation and devaluation just as Mexico has experienced during the six year term of Miguel de la Madrid, who applied the same ineffectual measures to achieve stability as the government is now trying to implement, ending his term in 1987 with inflation and devaluation rates of about 150% (see tables 3 and 4 on pages 25 and 26 of the essay). Sure the problem is much worse now than it was at that time, since, today, Mexico enters into that vicious circle together with a problem of virtual bankruptcy of banks and companies that did not exist in 1982-83.

Can anything be done to solve these rather serious problems? The essay states there is a way. The solution has two phases. In the first period of four months, the Mexican financial system must be opened up to the immediate and full participation of North American commercial banks. At the same time constitutional guarantees must be given by Mexican Congress to let the dollar circulate as a second currency in the Mexican economy. This means that people may have peso or dollar accounts, as they wish, and that banks may give loans in pesos or dollars, as people wish. This means that a monetary multiplier is to be applied to the physical dollar reserve, as big as 1/s, "s" being the dollar reserve rate. For example, with a physical dollar reserve of 8 thousand million dollars and a dollar reserve rate of s=33%, the supply of dollars would be

(1/.33)*8 TMD = 24 TMD. By having the dollar reserve multiplied by such a normal monetary multiplier that operates when people can do business with the reserve currency, the supply of dollars will be several times the amount of physical dollar reserves in the hands of a Central Bank or a Monetary Council -according to the dollar reserve rate-. The supply will then be big enough to meet the demand and that will really stabilize the exchange rate.

After four months of opening up the economy to the use of dollars, the exchange rate will be fixed at its actual market value and a Monetary Council will be put into place. This Monetary Council, with a representative of the IMF and the USA government, and a majority of Mexican councilors, most of whom will be elected by civil society, will be independent of government and guarantee that the Monetary Peso Base will be backed up by the Physical Dollar Reserve, permitting free convertibility, just as is the case right now in Argentina. It is necessary to understand that Argentina's problems, right now, are slight in comparison with Mexico's problems, and do not result from their mixed Currency Board - Central Bank system, but rather from the absence of a savings insurance system together with the presence of many ineffective smaller, provincial banks. This problem has already been dealt with by the Argentine government after people withdrew 6 TMD from their dollar deposits (keeping those dollars temporarily at home).

During one month after the installation of this system, Mexican companies will be allowed to adjust their prices so as to correct the undervaluation of the peso at the moment that the exchange rate is fixed. After that, inflation rates will be equivalent to those of the dollar (the USA) and, of course, devaluation will be zero. This solution simultaneously tackles that problem of Mexico's inefficient banking system, permitting the operation of foreign banks and the association of Mexican banks with those foreign banks. That will put and end to the problem of the banks' insolvency and -after a few years- of the notes-due problem. Than the slow work of creating employment in the formal sector can start, facilitated by the transformation of the informal into the formal sector through a thorough deregulation process together with tax-simplification and reduction.

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-Entre Socialismo y Neoliberalismo [Between Socialism and Neoliberalism], IPE FKA, Mexico, 1992
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DIAGNOSIS OF THE ACTUAL CRISIS AND ITS POSSIBLE SOLUTION

This essay contains a diagnosis of the Mexican crisis and its causes. Afterwards we will review the government's adjustment program, so we can see if it needs any corrections and/or supplementary measures in order to accomplish success.

1.MISTAKES IN 1994

Economic policies between 1988 and 1993 created stability on one hand, but on the other, they put the producing sector in trouble. Before the outburst of the crisis in December, 1994, several problems existed within this sector. Among the main increasing symptoms we can find the increase in notes due by the manufacturing sector (graphs 1A & 1B) and the rise of underemployment (graphs 2A & 2B).

We will analyze the immediate causes of the high level of notes due of the Mexican economy in the Appendix on the Mexican banking system from 1992 to 1994.

1.1 THE OVERVALUATION OF THE NEW MEXICAN PESO

According to the CEESP's basic information (December, 1994), at the end of November, 1994 the New Mexican Peso (NMP) was overvalued by 25%,

even though (according to the Bank of Mexico*) at the time Mexican currency was undervalued by 8.8%! How can we explain such differences in terms of NMP under or overvaluation? The dollar's real value is indicated by the index of the real exchange rate. The "base" year for this index is the year in which the price of dollars was considered to be fair. The Bank of Mexico (BM) chose 1970 as base year, and the CEESP the year of 1977. Now, the real exchange rate index in 1994 was +7.4% over the index in 1970. This implies an undervaluation when both indexes are compared. The argumentation favoring 1977 is that in this year, the commercial balance had no deficit or surplus and the prices of consumable goods in the United States were the same as in Mexico.

We can find a mistake in the method used by the Mexican Bank when calculating external inflation. The difference of external and internal inflation determines the evolution of the real exchange rate index. The Bank also weighs other countries' external inflation according to their participation in the world's gross national product (See Informe Anual 1986 del Banco de México, p. 134), no matter if Mexico hardly had any commercial transactions with these countries. In 1989 two thirds of all imports came to Mexico from

* Bank of Mexico: Mexico's Central Bank

the United States, and 8 to 12% from Germany and Japan.

External inflation should not be weighed according to these countries' share in the world's gross national product. It should be weighed with Mexico's imports, as I state in my book, Macroeconomics (UIA, 1993 pp. 152 - 153). The BM's method shows that there is an overestimated external inflation. The negative variation of the real exchange rate in 1989 was not of -1.9%, as the BM stated. The real variation was of -7%, and in 1990 it was of -15.8%, instead of -9.5%. These mistakes by the BM explain the currency's undervaluation (of course, according to the Bank), when what in fact existed was an overvaluation. By January, 1994 the sales slip could have been raised from 0.0004 NMP to 0.0025, and the existing 25% overvaluation could have been disappeared in one year (from 3.1 NMP for a dollar in January to 4.1 by December). Since there was no adjustment for the exchange rate slip, the first big mistake of 1994 was made.

1.2 TESOBONOS[1]

Instead of adjusting the exchange rate, the government decided to issue and quote treasury bonds massively, and traded them for Cetes[2] bonds, which was the second mistake of the year. Before this trade a negative variation of the real exchange rate was convenient for investors, since they received higher profits. It was good for the government too because it was the anchor of its trade and monetary stability.

Since the stock market was not being controlled by the government, the latter raised the Cetes bonds rate when investors withdrew from the stock market (graph 3). There was an oscillation in foreign investments for fixed income and for current income, but the management of the rate for notes issued by the government guaranteed profits for investors, in order for th m to keep their money inside the country. Managing this rate allowed for the compensation of the trade balance and Current Account deficit which was created by the negative variation of the real exchange rate (graph 4) by means of the foreign investments portfolio in the Capital Account. It was very important to manipulate this rate so that the surplus in the

[1]Tesobono: Bond indexed to the real exchange rate.
[2]Cetes: Mexican version of a treasury bill.

Capital Account would compensate the deficit in the Current Account (graph 5). In 1994 the deficit in the Current Account was proportionally double to the one registered in Argentina (almost 8% of the gross national product). Because of this deficit and the country's political instability arose questions about the government's capability to fulfill its promise of avoiding a devaluation. Gossiping about a possible devaluation of Mexican currency started, that is, about a high positive variation of the real exchange rate that threatened the investors' profits.

Due to this situation, President Salinas de Gortari's administration raised the issuing and quoting of treasury bonds in a drastic way (the so called Tesobonos). These bonds were sold and bought for NMP, but they were protected against the effects of a possible devaluation, since they were valued in dollars. When they were traded for NMP, the rate was the same as the day's dollar exchange rate. These bonds did not only protect investors against exchange risk, but they also offered a premium on devaluation that would be as big as the devaluation would be. Their interests were not threatened by a devaluation anymore, on the contrary, now there was a profit in addition to the Tesobonos´ rate. The investors played the game, and during the year, they exchanged notes

issued by the government for tesobonos (graph 6). 80% of all Tesobonos were in foreign hands (graph 7).

During the first 19 days of December, the dollar reserves decreased quickly. In a meeting with industrial leaders, the government announced the flotation of the exchange rate, but postponed it for two days, giving these people more time to buy dollars. (the "December mistake"). After the announcement of the 53 cent slip, from the morning of December 20, until the December 21 devaluation at noon, the BM lost about four thousand million dollars. Withdrawals from the stock market were a logical thing to do and this caused a crack (graph 8A) that made the government raise the CETES rate that is now at almost 80%. This allows the trade to be the other way around: selling the Tesobonos obtaining a 100% exchange profit, due to the devaluation, and after that buying CETES once again (graph 8B).

Here we criticize two things. On the one hand the fact that the government has played an erroneous role. The massive trade of CETES for Tesobonos invited the investors to change the rules from a collaboration to a conflict game. On the other hand, we criticize the fact that this game became the master key of the exchange

rate and monetary stability, instead of remaining marginal in the country's economy.

The BM has rendered an explanation about the decrease of 1994 reserves which turned up to be very controversial. In page 30 of the book Exposición Sobre la Política Monetaria (Monetary Policy Exposition) they attribute the capital flights to other countries in 1994 which totaled more than 18 thousand million dollars to "external shocks". According to them, these shocks were the killing of Luis Donaldo Colosio in March; Jorge Carpizo's resignation threat in June; the accusations made by the Sub Minister of Justice, Mario Ruiz Massieu in November; and the threats made in December by the EZLN (A revolutionary army in the state of Chiapas).

These explanations lack credibility. Should murders cause the flight of capital, why was there an increase in the country's reserves after the murder of Ruiz Massieu in September (graph 9)? Also, if hostilities by the EZLN caused the same phenomena, why did the original aggressions in January, 1994 produce the country's reserves to grow by almost four million dollars (graph 9)? If facts sometimes corroborate and sometimes contradict a hypothesis, the hypothesis in such a case is falsified. Only if facts

ALWAYS corroborate the hypothesis, it stands in a firm position (The Logic of Scientific Investigation; Karl Popper, 1980).

1.3 The increase of the net internal credit in 1994.

We have already highlighted two mistakes, to which we can add a third one: the injection of an enormous amount of NMP's into the economy due to the rise of the net internal credit (over 130%) in May, 1994, in preparation of the presidential elections (graph 10). This money did not result in an immediate inflationary pressure, since a large amount of it ended up in the purchase of dollars destined for goods importing (graph 11) due to tne fact that many of these imports were cheaper than national goods. Another part of this internal net credit was given to the Banco de Desarrollo (Bank for Development). In 1992 the National Treasury Department (SHCP) came up with a new definition of net public expense. This allowed the cover up of the 1994 financial deficit which was not 0.4%, but (including the financial intermediation) almost 5% (graph 12) of the GDP.

If the BM would have acted in a more conservative manner, the dollar reserve decrease, after

Colosio's murder, would have caused a monetary restriction and, therefore, an interest rate raise for CETES and all other rates. However, these rates decreased from April to November, instead of increasing (graph 3), as they should have. But since this policy would have stopped the economical growth before the elections, the BM overcompensated the internal asset decrease with the net internal credit, therefore, giving more money to the country's economy.

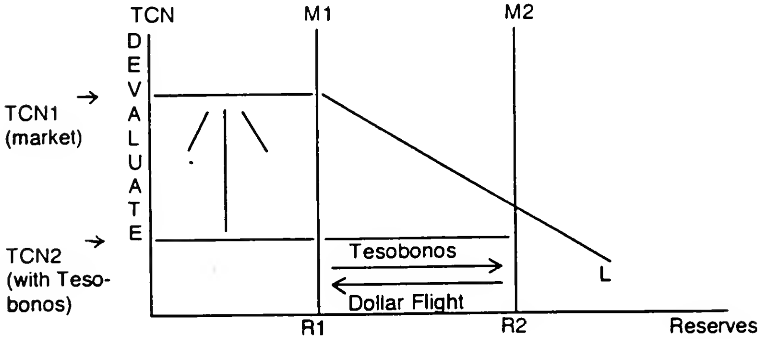
When economic agents foresee a devaluation, dollar demand is stressed and the slip imposed by the Bank is more and more unsustainable. This is nothing new. Because of advice given by the International Monetary Fund (IMF), many third world countries quickly developed an exchange rate system with an imposed slip by their Central Banks, leading them to failure. Mexico is the only one that has fallen four times into the same trap (1976, 1982, 1987, 1994).

In his book, Currency Boards for Developing Countries, Steve Hanke comments with an astonishing precision the events of 1994 with a pegged exchange rate, even though he is not speaking about Mexico directly:

"Overvalued exchange rates in a country with a pegged exchange rate can result from ... domestic inflation. A typical Central Bank maintaining a pegged exchange rate tends to inflate, which causes the monetary base to increase faster than its foreign reserves. Consequently ... the Central Bank loses foreign reserves as people buy more imports and as currency speculators bet that the loss of foreign reserves will induce the Central Bank to depreciate the currency" (pp. 15-16).

Summarizing: the NMP´s overvaluation and the increase of net internal credit generated stress upon dollar demand and, as a consequence, a difference between dollar demand and supply that could be closed temporarily by the massive issuing and quoting of Tesobonos (scheme 1).

SCHEME 1 CAUSES OF THE DEVALUATION, DECEMBER, 1994



L= Dollar Demand Curve

M1= Dollar supply curve (without Tesobonos)

M2= Dollar supply curve (with Tesobonos)

R1= Demanded dollar amount on market exchange rate

R2= Demanded dollar amount on overvalued NMP rate

R2-R1= Perceived dollars by Tesobonos

R1-R2= Flight of capitals by Tesobonos unquoting

TCN1= Market exchange rate

TCN2= Overvalued NMP exchange rate.

2.OPINION OF THE GOVERNMENT'S ADJUSTMENT PROGRAM

February 21, 1994. SHCP and BM signed an agreement with the American Treasury Department. March 9, 1994, the SHCP secretary gave a T. V. announcement, where he dictated an adjustment program, which was published the following day. These documents are basically identical, even though we can see a huge difference on the public income part (scheme 2).

SCHEME 2 FEBRUARY 21ST. AGREEMENT AND MARCH 9TH. PROGRAM

FEBRUARY 21ST. AGREEMENT	*MARCH 9TH. ADJUSTMENT PROGRAM*
Exchange Policy: "Our immediate objective is to create conditions ... which will stabilize the exchange rate."	It is obvious that within the proposed floting regime, BM monetary policies will function as an anchor that will allow the exchange rate stability recovery.
Monetary Policy: "BM has adopted a limit for its internal net credit expansion of 10,000 million NMP ... below the rate of inflation."	"BM engaged not to raise its internal credit over 10,000 millions of NMP."

Fiscal Policies: Public Expense

"According to the agreement with IMF, Mexico will achieve a financial surplus of 0.3 % in 1994 and reducing the Development Bank´s credit in relation to 1994." "Unbudgeted governmental expense will be diminished in 1.3%.

"Primary surplus will increase the from 2.3% of the Gross Domestic Product in 1994 to 4.4% in this year." "Budgetable governmental expense will be diminished 9.8% in real terms."

Public Income:

"The government is engaged to carry on with privatization and concessions which can render between 12 and 14 million dollars within the following 3 years."

"Gas and Diesel prices will be raised in a 35% ... starting Apr. 1 ... VAT tax will be raised from 10 to 15%."

Financial System:

"BM will take measures in order to face cash flow problems in the bank sector ... without breaking the credit program ... solvency problems will be solved using the Savings Protection Bank Fund."

"A new long term restructuration program by viable companies ... will cover notes due u 65 thousand millions of NMP... The Savings Protection Fund will continue protecting bank depositors."

The agreement with the United States at the end of February and the adjustment program at the beginning of March match on their basic points, excepting public income policies. The adjustment program seeks them by raising the VAT tax and public prices . We think that the VAT tax raise was a mistake which will carry on political cost for the party which

imposed it through the executive and legislative powers.

2.1 THE BACKUP ECONOMIC THEORY FOR THE PROGRAM IS DEFICIENT

Our intention in this essay is not to go into the program's details, but into its base theory. This theory says that exchange rate stability will be recovered by monetary stability and that the latter would be regained by means of a drastic reduction of internal demand and of the real amounts of money in the country's economy. The adjustment program does not deny that this reduction will produce a severe recession, but it argues that there is a price to pay for stability recuperation.

This theory states that there exist certain causal relationships, two of which are controversial. The theory supposes that an excessive amount of money in the economy is responsible for inflation. Hence, the program states that "a restrictive enough monetary policy ... will permit the recuperation of ... price stability." The program also considers that the most important cause of exchange rate instability is monetary instability. Is states that "it is obvious that in a floating exchange rate regime BM´s monetary policy will be the anchor for allowing for the recovery

of the exchange rate stability." Combining these two causal relationships, the program affirms that "the recovery of the exchange rate stability can be achieved by the adoption of a restritive enough monetary policy."

This governmental theory behind the adjustment program cannot stand the confrontation with reality. The idea that M1's variation is the only cause of inflation is wrong. It is, indeed, a part of it, but not all. With an econometric program (FCP), a multiple regression of the inflationary rate can be established in Mexico from 1970 to 1995.

$$\begin{aligned} \text{INFLATION} = \; & +0.40*(\text{INERTIAL INFLATION}) \\ & +0.37*(\text{M1 VARIATION}) \\ & +0.19*(\text{DEVALUATION}) \end{aligned}$$

This model generates a very precise prediction of the inflationary rate from 1970 to 1994 (graph 13). The nominal M1 20% raise, with an expected 42% inflation and an annual devaluation of almost 150% would give us an inflation rate, in 1995, of:

$$\text{INFLATION} = 0.40 * (42\%) + .37 *(20\%) + 0.19 * (147\%) = 52\%$$

In the following economic cycle, expected inflation would equal that of the preceding one; that is, 52%, which would give us, in case money (M1) variation and devaluation would remain the same, an inflation rate for 1996 of 56%. The inflationary trend would rise, not decrease, with the government's remedy, no matter how draconian it is.

According to the government's theory, exchange rate stability will be accomplished by the means of price stability. We consider it to be the other way around, instead: One causant of monetary instability is exchange rate instability (as shown above). Exchange rate stability depends on the equilibrium between the dollar's supply and demand. Therefore, exchange instability is caused by the particular circumstance where dollar demand is totally above supply. If this goes on, given a reduced and stable supply, a devaluation much above inflation will exist. In fact, a savings transfer trend from small banks to big banks and from the national banking system to abroad exists, and will keep on existing; which means stressing dollar demand.

The floating exchange rate has been applied in Mexico since December 22, 1994 up to date (graph 14A) Based upon the empirical exchange rate evolution until

the beginning of April, it would reach between 6 and 11.NMP/dollar in December, 1995 (graph 14B), which would mean a 147% annual devaluation.

The program assumes that this trend will not be linear but parabolic; that is, the trend for devalution would be reverted e. g. starting from April, 1995. However, this new declining trend can be reverted again, just as it happened during Miguel de la Madrid's presidential period (Tables 3 and 4). The causant of this new rise of inflation and devaluation trends is the following: At a very short term, the devaluation is a contributor to the inflation because the price of imported parts and raw materials rises. But on a medium term, the influence of the devaluation upon inflation is due to the pressure of the prices of imported finished goods , compared to those of national finished goods. The prices of national products use to adjust themselves to external prices and, because of this inflation the competitive advantage that was momentarily obtained due to devaluation is lost.

The latest economic research about the interaction between inflation and devaluation concludes as follows: "Devaluation has tended eventually to show up in higher prices: a 10% devaluation has, in the long run, caused a 10% rise in

producer prices, leaving competitiveness back where it started. The only question to answer is how long the process takes?" (The Economist, March 25, p. 86).

The following table allows us to see this in a much more clear way, based upon Mexico's recent case:

Table 1 Potential Inflation Due to Devaluation.

Product	USA Price	Present Price	Price at an exchange rate of N$6	Inflation due to price adjustment
Big Mac	2.00	13.90	12.00	-7.3%
Levis	42.00	230.00	252.00	+9.6%
Pizza	12.25	45.00	73.50	+63.3%
Milk	2.69	9.07	16.14	+77.9%
Newspaper	0.050	3.00	3.00	+0.0%
Beer (6)	3.50	12.00	21.00	+75.0%
CD's	15.00	45.00	90.00	+100.0%
Light Bulb	0.59	2.10	3.54	+68.6%
Breakfast	3.00	9.00	18.00	+100.0%
Haircut	10.00	40.00	60.00	+50.0%
Movies	5.00	10.00	30.00	+200.0%
Coke	0.50	1.50	3.00	+100.0%
Chicken	0.79	8.00	4.74	-40.8%
Bread	0.50	2.60	3.00	+15.4%
VW Jetta	16000.00	75000.00	96000.00	+28.0%

Data based on Reforma: March 24, 1995, Section A.

Up to this moment, our criticism of the government's theory has only demonstrated that they do not face the devaluation as an important cause of inflation in a direct way. In fact, we can take our

criticism one step further by signaling that even in the part where their idea is correct (where they state that the variation of M1 is a cause of inflation), its implementation is deficient, as it will be shown.

The hundreds of thousands of consumers that will lose their jobs will withdraw their savings from the financial system, in order to use them in their normal consumer activities. With the new Investment Units Program, companies with notes due will stop paying their debt's principal during several years of grace, and will only pay a real interest rate. This program covers only 19.4 % of all outstanding credit (108.6 thousand millions of NMP of a total of 559.2 TMNMP). Therefore, the majority of companies having notes due, and of people whose properties are mortgaged will keep on being unable to pay what they owe. There will be a massive problem of decreasing savings at the same time that the government encourages people about the importance of an internal saving increase! That is why, if the program on one hand means an important relief for companies that accomplish qualification, it is on the other hand, not solving the banks' cash flow problem.

Given the fact that banks obtained government bonds in exchange for the notes-due-documents from a

trust fund (the trust fund issued Bonudis in order to get these bonds from the government), banks having cash flow problems will have to trade their bonds issued by the government for cash. Should this happen in a massive way (a likely situation), the anchor of the adjustment program, that is, monetary restriction would be severely threatened by the need of rescuing such banks.

2.2 A GREAT MEXICAN DEPRESSION?

The risk for the repetition in Mexico of an analogous situation to that of the Great Depression (1929-1933) is not too far. In 1929 the U. S, government reacted to the crisis with a reduction of the real amounts of money of -4% and a reduction of public expense which provoked a -87% investment and a -19% consumption decrease. Since the diminition of the demand was larger than the reduction of the real amount of money, the depression (that lasted for several years) coincided with a trend where the interest rates were diminished. Now, in Mexico, the restriction of the real amounts of money (-20%) doubles the reduction of private consumption (-10%) and of demand in general: which will cause a negative growth (graph 15A) coincidental to an increment of interest rates (graphs 15 B). In other words, there exists danger that the recession transforms into a depression

which might last for several years, coinciding with inflation (graph 15C) (this is a severe form of the stagflation suffered by Mexico during de la Madrid's period).

A Harvard economist, Gregory Mankiw asks the question: "Could the Depression happen again?" (Macroeconomics, Worth Publishers, 1992, p. 283). He answer the question by saying to himself that it is most unlikely: "Most economists believe that the mistakes that led to the Great Depression are unlikely to be repeated. The Federal Government seems unlikely to allow the money supply to fall by one fourth ... Fiscal policy in the 1930's not only failed to help, but actually further depressed aggregate demand. Few economists today would advocate such a rigid adherence to a balanced budget in the face of massive unemployment..." (P.283).

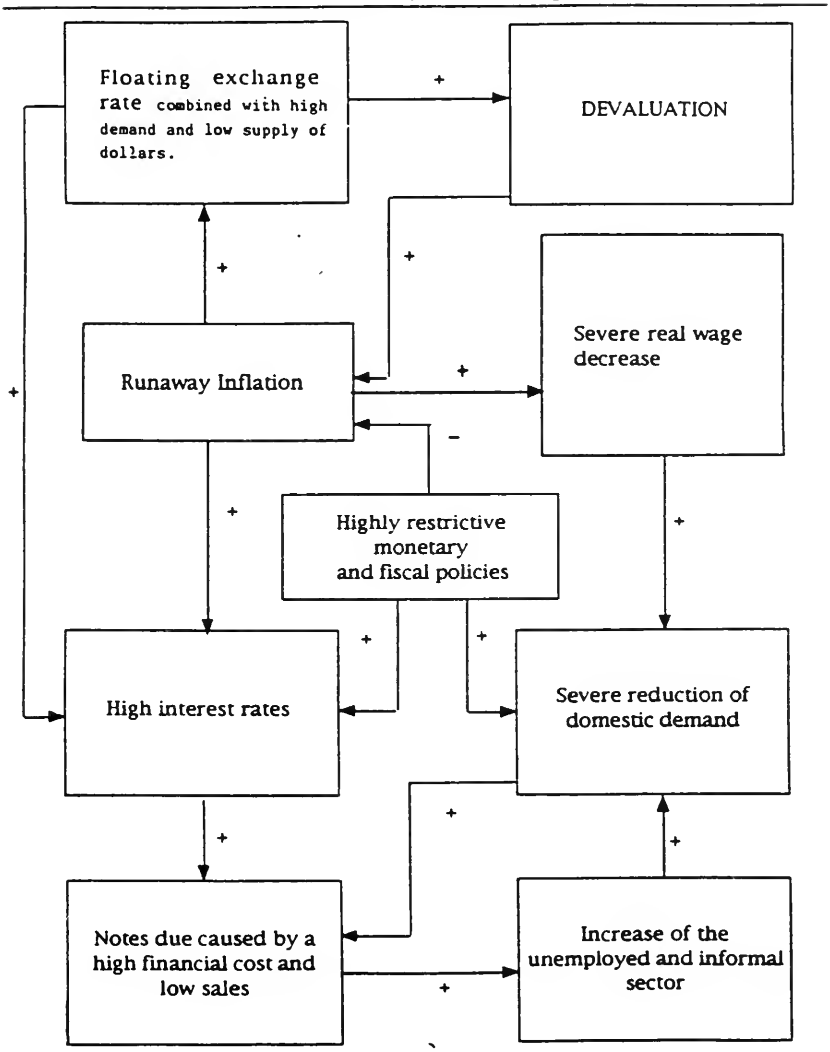
In fact, the adjustment program not only repeats these Great Depression policies, but the repetition is made in a more severe manner. Public expense and aggregate demand reductions are similar, but the reduction of the real amounts of money is not -4%, it is a lot higher; more or less -20%. Even in this case there will be a rise in the nominal amount of +20%, which will cause a 7 percentage-points rise of the inflation rate. The problem is that these policies are repeated in a

situation where prices do not decrease (like in 1929-1933); in fact, they are increasing. When inflation is not faced directly in two of its three causes (that is the devaluation resulting from the pressure of the demand for dollars and the inflationary expectations which causes inertial inflation), the adjustment program provokes a much more severe reduction of the real amount of money. Therefore, the current monetary and fiscal policies are more recessive than the ones that transformed the 1929 recession into a Great Depression. The government does not deny the recessive effects of their adjustment program, but states that there is no other choice and that if their solution is not implemented, things would be even worse. But I think that the adjustment program could be less recessive if it faced these two causes directly (devaluation and inertial inflation), as we will see.

It is now time to summarize our criticism. THE RECUPERATION OF EXCHANGE RATE AND MONETARY STABILITY IN A FLOATING EXCHANGE RATE REGIME, THROUGH SEVERE MONETARY AND FISCAL RESTRICTION IS SLOW AND INSECURE; EVEN IN THE NOT SO SURE CASE OF SUCCESS AFTER SOME YEARS, THE PRICE PAYED BY SOCIETY IS VERY HIGH, RUNNING THE RISK OF A CHAINED BANKRUPTCY OF BANKS AND COMPANIES, INCLUDING THE MASSIVE UNEMPLOYMENT THAT THE SITUATION ENCLOSES.

We present the current situation with the adjustment program in scheme 3. The arrows with a (+) sign symbol a positive cause relation between the phenomena; the arrows with a (-) sign stand for negative relations.

Sheme 3: The Government Adjustment Program for the Crisis



3. AN ALTERNATIVE ADJUSTMENT PROGRAM.

3.1 Antecedents from prior presidential periods.

In order to find solutions to our problems, we can use prior experiences in situations of the kind. In 1982 and in 1987 there existed a devaluation and a runaway inflation in Mexico. From 1983 to 1987 a stabilization program was used, it failed. From 1988 to 1992 stability was accomplished, but annihilated by the terrible mistakes in 1994. Nowadays, everybody speaks poorly about the administration of the former President, Mr. Carlos Salinas de Gortari. We share not such an opinion. We think that some of his economic policies from 1988 to 1992 were successful and accomplished exchange rate and monetary stability, and that the mistakes of 1994, which led to the country's crisis, could have been avoided easily if it was not for a collective blindness of some government leaders that did not want to rectify their course of action in 1994 and that were being flattered by some private sector leaders.

Why did the adjustment program work from 1988 to 1992, and why did not the one from 1983 to

1987? Certainly it did not have to do with monetary expansion, because it was equal in both periods (table 2), during the first 3 years.

Table 2: M1 growth 1983-1987 and 1988-1992

	1	2	3	4	5	1 to 3	1 to 5
MMH	41.4%	62.3%	53.8%	72.1%	129.7%	353%	1395%
CSG	58.1%	40.7%	60.3%	118.3%	15.1%	356%	856%

The difference lies in the fact that from 1983 to 1987 we had a floating exchange regime and from 1988 to 1992 a heterodox stabilization program, that succeeded well, since its anchor was fixing the exchange rate (table 3).

Table 3: Devaluations 1983-1987 and 1988-1992

	1	2	3	4	5	1 to 5
MMH	8.7%	30.1%	113.1%	104.5%	143.4%	1498%
CSG	3.1%	16.7%	9.8%	4.5%	1.4%	40%

The success of the adjustment program from 1988 to 1992 and the failure of the one from 1983 to 1986 is due to the exchange rate management. Table 4 allows us to see the evolution of the inflation rate in both periods.

Table 4: Inflation Rates: 1983-1997 and 1988-1992

	1	2	3	4	5	1 to 5
MMH	80.8%	59.2%	63.7%	105.7%	159.2%	2512%
CSG	51.7%	19.7%	29.9%	18.8%	11.9%	314%

Now, there exists room for objecting that this almost fixed exchange rate caused the overvaluation of the NMP. We agree. There was a time lag between the evolution of the inflation and devaluation rates. which produced a negative variation of a real exchange rate, that is, the overvaluation of the NMP. The following question then arises: Could we take the positive elements from the 1988-1992 adjustment program without creating a NMP overvalue at a medium term? We think that this stabilization technique exists, as we will now see.

3.2 Dollar supply raise

The pressure of dollar demand over NMP can be neutralized by having a larger dollar supply. Many people think that it is impossible to “create” dollars; this idea, however, is wrong. It can be done as long as we apply a multiplier defined by a dollar rate reserve to the physical dollar reserves. With a 50% reserve rate and an 8,000 million dollars physical reserve we could

accomplish a 16,000 million dollar supply, and with a 25 % reserve rate we would have a 32,000 million dollar supply.

How can this be put into practice? This can be done by allowing all individuals and companies to have dollar deposits and allowing national and foreign banks to manage savings and credits in dollars. The multiplier is nothing else but the chain of deposits transformed to credits which are converted into new deposits, and so on. This way, cash money(the monetary base) is multiplied.

The people to whom we have talked about this do not deny that theoretically speaking this would raise the dollar supply, pressing the exchange rate downwards. These people, however, always make warnings about what happened in 1982 when President López Portillo's government confiscated all "Mexdollars", paying the dollar account holders a few pesos for their dollars. The difference between 1982 and 1995 must be exposed. In 1982 there existed no democracy and the governmental party had the absolute majority that enabled them to change the country's Constitution at will. In 1995 this same party does not have the same amount of power anymore, and if the four most important political parties (PRI, PAN, PRD, PT) would establish the constitutional right for

having non confiscable accounts in dollars, and to make business with them, this would guarantee the accomplishment of trust by dollar account holders.

At the beginning a 50% bank reserve dollar rate could be fixed, and gradually, as the measure obtains the people's trust, the rate can be lowered to 33%, 25%, etc. After three or four months, when people have opened accounts and started making business in dollars, the other phase of our stabilization plan would come in vigor. This is changing from the floating exchange rate regime to a Monetary Council system with a fixed exchange rate.

3.3 The Monetary Council with Exchange Rate and Monetary Stability

The exchange rate will be fixed. THE MONETARY BASE MUST BE BACKED UP BY AN EQUIVALENT RESERVE IN DOLLARS (graph 16) so that any individual and company can change their NMP (cash) for dollars, anytime. FREE CONVERTIBILITY would exist and it would be guaranteed by law. Money exchange offices would be transformed into counters of the issuing Council, or Monetary Council. All individuals and companies may have bank deposits in dollars and/or NMP. Major transactions could be made in

dollars. Of course, this link between NMP and dollars makes it necessary to control public expense and debt and to avoid the overdraft of public bonds. Exchange and monetary stability will allow public debt bonds to be in longer terms and for amounts lower than the ones there used to be. All this allows lower interest rates.

How does this monetary—exchange rate system work when put into reality? A Monetary Council will be ruled by law, and its functions will be well defined. Given the political pressures to which the Council would be exposed, by-laws are not enough; the force and precision of the law are necessary.

Even though the fixing of the exchange rate in its current market value implies NMP to be undervalued, the factors which raise the dollar demand do not leave any other choice. Due to undervaluation, a passing by imported inflation will be unavoidable. After the installation of this system all companies are allowed to make adjustments in their prices during one month. Future raises will be prevented by an Agreement ("Pacto"). Afterwards, the Mexican and the American inflation rates would be on the same level.

The Monetary Council holds a reserve equal to or larger than the amount of monetary base (or the amount of M1). In regard to the system's implementation (in the case of Mexico) it could be preferable that during 1995 the amount of M1 remained backed up by dollars, but in 1996, it would suffice to backup the Monetary Base. The more restrictive formula for 1995 would be like a cushion against the lack of confidence originally created by this new system.

One question regarding this system may rise: How can the Current Account's deficit be financed? Obviously, like in any other system, it would be financed by surplus in the Capital Account, and vice versa. The excessive deficit in the Balance of Trade is not avoided by devaluations, but by the raise of the interest rates for credits in dollars. If an imports company does not have reserves in dollars of its own, and is forced to ask for a credit, dollars would become more and more scarce, and the interest rates of such credits and deposits would rise. These high rates would increase, on one hand, the entry of dollars by the Capital Account, and on the other hand, they would discourage the imports excess, and therefore, the market would equilibrate the Balance of Payments.

The federal government's need for issuing bonds is lowered within the system to almost zero, because on one side, a deficit larger than the one established by the law is not allowed, e. g. 1% or 2% of the gross domestic product, and on the other, there would be no need to issue and quote bonds with high interest rates to perceive dollars as a backup for the NMP, since the monetary base is already backed up by the Monetary Council's reserves. The Federal Government's bonds would be long term and for relatively small amounts in this system. BM's monetary policy in an open economy with fixed exchange rate is necessarily accommodating. The new Monetary Council system does not change this circumstance. BM may operate in the secondary market buying and selling bonds, and it can also fix the bank reserve rate. This last operation has no effect on the level of the monetary base, but on the amount of the monetary multiplier applied to this Base and has an effect on the M1 level; that is, BM still have some functions for monetary regulation, even though it loses some others. It is also possible that SHCP would assume such functions that are not in the hands of the Council, and this would mean the disappearance of the BM.

The main objection against this system is that monetary sovereignty would be lost. It is necessary to consider, in the first place, that in an open economic

system, an independent economy is a myth, as stated by Robert Reich in his book The Work of Nations (New York, 1992). "There will no longer be national economies" and "Borders become evermore meaningless in economic terms". The crossroad is not between "losing economical sovereignty" or "not losing it", but among:

A) "sacrificing some of the economic independence in an intelligent way" or

B) "sacrificing it in a risky way by the means of six years devaluations", like in 1976, 1982, 1987 and 1994. In this essay´s context, there are two concrete options:

   i) some of the financial independence is lost by allowing the use of dollars in the national economy;

   ii) financial independence is lost by allowing financial and exchange rate stability to depend on foreign and anonymous investors, and by allowing the future adjustment programs to be determined by the IMF and the U. S.

Other people object to the Monetary Council system by stating that in this system "external shocks" have an effect on the "real sector of the economy", meaning the productive sector. This is the same case as with the other objection. The question is not whether external shocks have an effect upon the real sector of the economy, but in which monetary-exchange rate system does this sector suffer more? We can compare Mexico's and Argentina's systems: both suffered external shocks caused by the lack of confidence of foreign investors, but:

1)Argentina's free convertibility system (with a fixed exchange rate) was strong enough, and the country suffered no devaluation; the Mexican pegged exchange rate system was not strong enough, and a disastrous devaluation came up.

2)Argentina's system needed a few thousand millions of dollars from outside to cushion the shock, and prevent instability (their inflation continues close to the dollar's); the Mexican system lost stability and needed tens of thousands of millions of dollars guarantees, conditioned in much more recessive measures to try to recover stability: Argentina's economy will have a growth rate equal to zero in 1995, Mexico's will be -4% to -5%.

We can see then that the effect upon the real sector in Argentina is much less severe than in Mexico.

Finally, there exist people who object to the Monetary Council system stating that the BM will not be able to rescue those banks that have cash flow problems. This is true for national banks. Some banks could fall into bankruptcy, in the same manner in which some companies could fall too. Savings protection must exist through the Savings Protection Bank Fund, which could be nurtured by an obligatory savings insurance and external resources. Our proposal supposes and includes an immediate foreign participation in the financial system. These foreign banks do not have cash flow problems and have large enough dollar reserves to backup dollar demand in the Mexican economy. This way, the proposed system in this essay will be strong enough against shocks caused by the savers' lack of trust.

The government says there exist no other choice, except their adjustment program. This essay proves there does exist another option and that the argument is not over yet.

Dr. Juan Auping Birch

APPENDIX WHAT WENT WRONG WITH THE BANKS BEFORE THE DECEMBER CRSIS

The Salinas government sold the banks at a very high price (see table 1), twice the actual value of the assets. Banks were reprivatized at a selling price of 13 thousand million dollars, when their actual value was 6.5 thousand millions dollars.

TABLE 1
SOURCES AND USES OF THE INCOME DERIVED FROM SELLING PUBLIC ENTEPRISES ("PARAESTATALES")

Selling price		Destiny of the money earned	
BANKS	N$ 38,969 mill.	Paying debts	N$ 57,775 mill.
Telmex	N$ 17,713	Other expenses	N$ 5,024
Others	N$ 4,960	Credit balance	N$ 8,053
Ficorca	N$ 7,085		
Interest	N$ 2,126		
Total	N $70,852 mill.	Total	N$ 70,852 mill.
Source: Pedro Aspe, SHCP			

The new private owners were protected by government against foreign competition in order to make society pay for their investment. This was accomplished by increasing the differential between the interest rates on savings and the interest rates on loans to usurious heights (see table 2).

TABLE 2
DIFFERENTIAL BETWEEN INTEREST RATE ON SAVINGS AND ON LOANS IN NEW MEXICAN PESOS FOR THIRTY DAYS TO FOUR YEARS, MAY 1993

Amount of credit according to type of client: B=General A=Qualified	Interest on loans	Several interest rates on savings: Chq.acnt 5 a 9999	Chq.acnt 10000	Fixed deposits	Fixed deposits
		14.05%	14.70%	16.34%	16.76%
Personal credit	36.16%	22.11	21.46	19.82	19.40
Credit, N$299 B	36.2%	22.15	21.5	19.86	19.44
A	33.7%	19.65	19.0	17.36	16.64
N$300 a 999 B	28.9%	14.85	14.2	12.56	12.14
A	27.4%	13.35	12.7	11.06	10.64
N$1000 a 4999 B	25.8%	11.75	11.1	9.46	9.04
A	24.8%	10.75	10.1	8.46	8.04
N$5000 a 9999 B	24.3%	10.25	9.6	7.96	7.54
A	23.6%	9.55	8.9	7.26	6.84
10000 a 19999 B	24.3%	10.25	9.6	7.96	7.54
B	23.5%	9.45	8.8	7.25	6.74
20000 B	23.3%	9.25	8.6	7.05	6.54
A	22.7%	8.65	8.0	6.36	5.94

The lack of foreign competition allowed for easy profits, from 1992 to 1993, without serious efforts to modernize the banking system. The relative inefficiency of the Mexican banks can be verified by a comparison with the American counterparts (see table 3).

TABLE 3
COMPARISON OF EFFICIENCY OF BANKS IN MEXICO AND THE USA, 1992

	Operational costs as % of assets	Operational costs as % of net income	Utilioty as % of net income
Mexico	4.8 %	24.4 %	7.2 %
USA	2.1 %	11.2 %	11.6 %

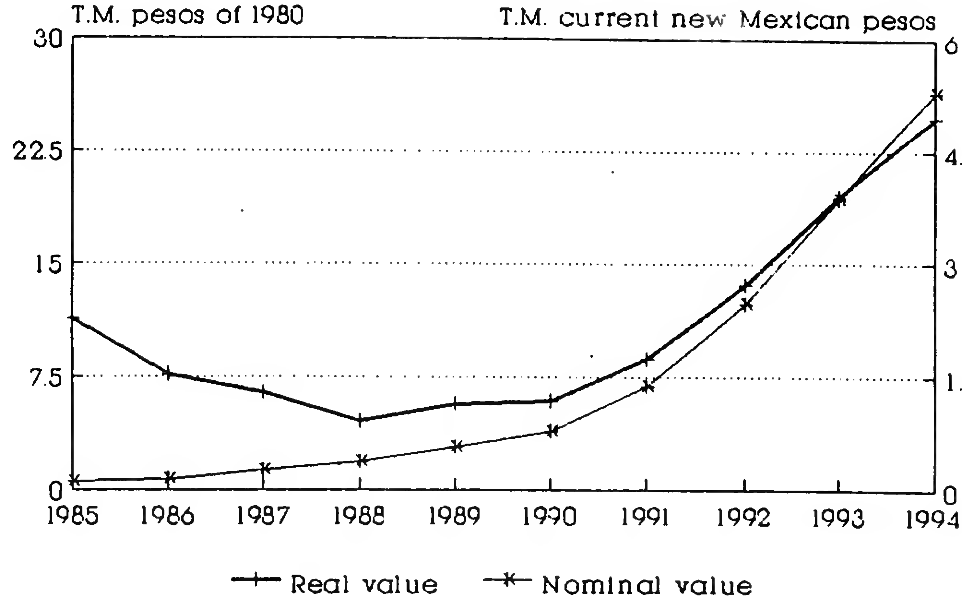
Source: Annual Report, Fortune, 1992

The combination of usurious interest rates and notable lack of efficiency explain the alarming increase of notes due, in manufactures (graph 1A) and in the economy in general (graph 1A).

GRAPH 1 A

NOTES DUE BY THE MANUFACTURING SECTOR

MEXICO, 1986-1994



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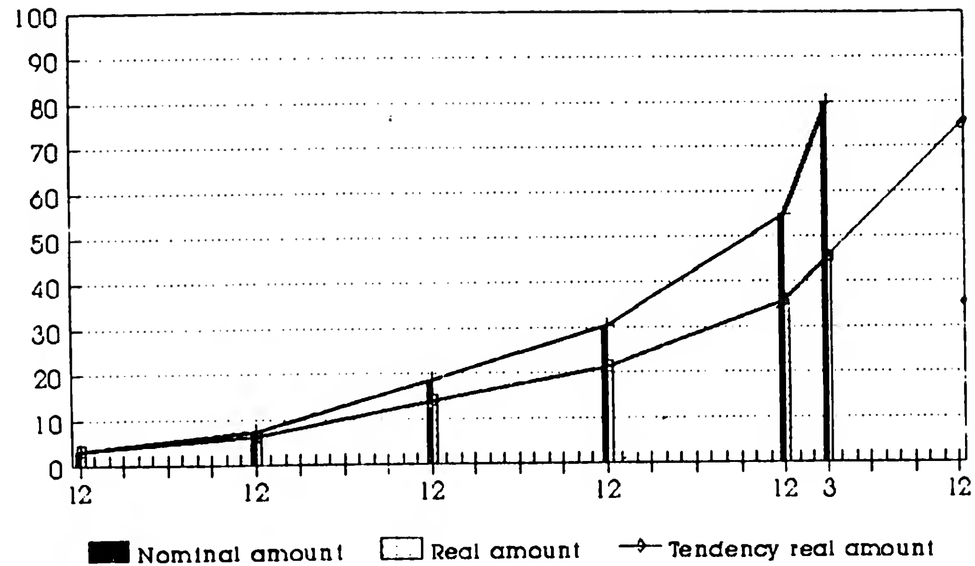
GRAPH IB

NOTES DUE, TOTAL ECONOMY

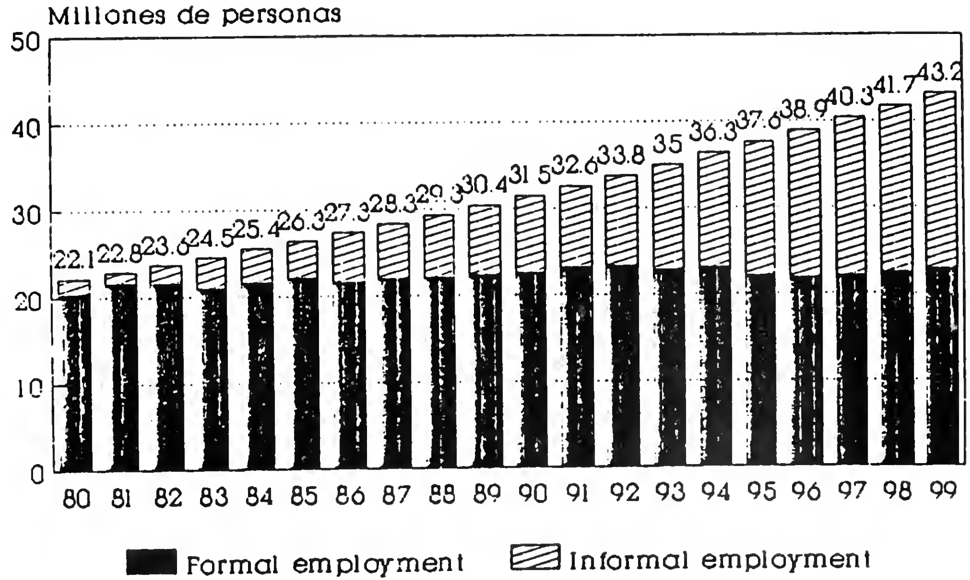
PESOS OF 1990, MEXICO 12/90 TO 12/95



Data Asociacion Nacional Bancaria
Casino31.

GRAPH 2A

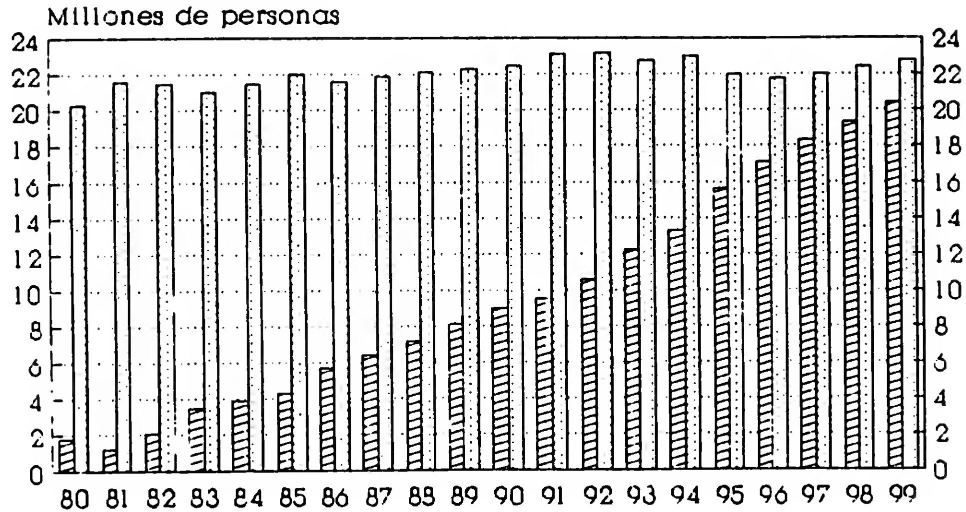
EMPLOYMENT IN THE FORMAL SECTOR AND EMPLOYMENT IN THE INFORMAL SECTOR



Source: CIEMEX-WEFA. Casino10

GRAPH 2B

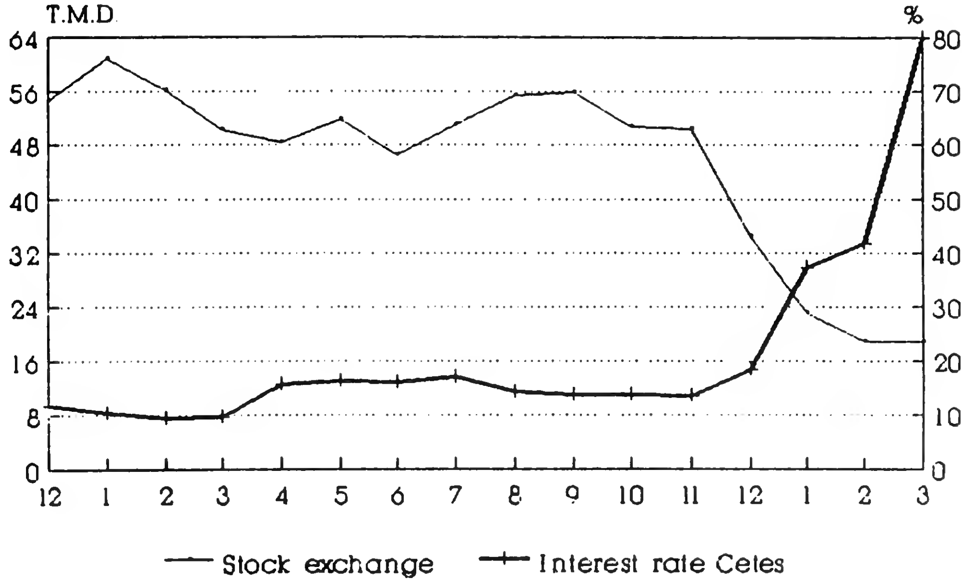
PEOPLE EMPLOYED IN FORMAL AND INFORMAL SECTOR, 1980-94 AND PROJECTION 1995-99



Source: CIEMEX-WEFA. Casinol0

GRAPH 3

FOREIGN INVESTMENT IN STOCK EXCHANGE AND IN CETES OF 28 DAYS, 12/93 TO 3/95

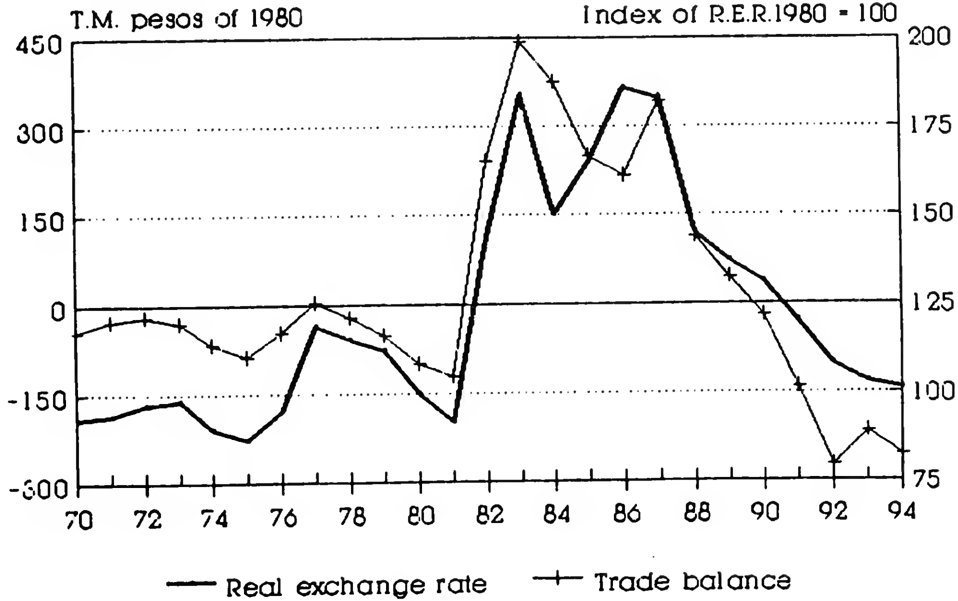


Data INVERMEXICO. Casinal9

GRAPH 4

TRADE BALANCE AND REAL EXCHANGE RATE

MEXICO, 1970-1994

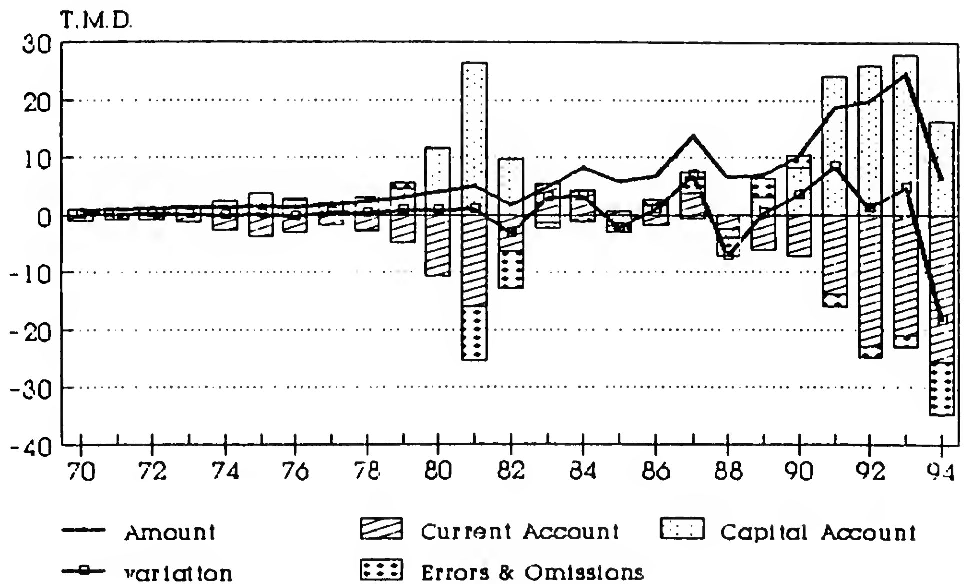


Source: Data Banco de Mexico. Casinol4

GRAPH 5

AMOUNT AND VARIATION OF DOLLAR RESERVE

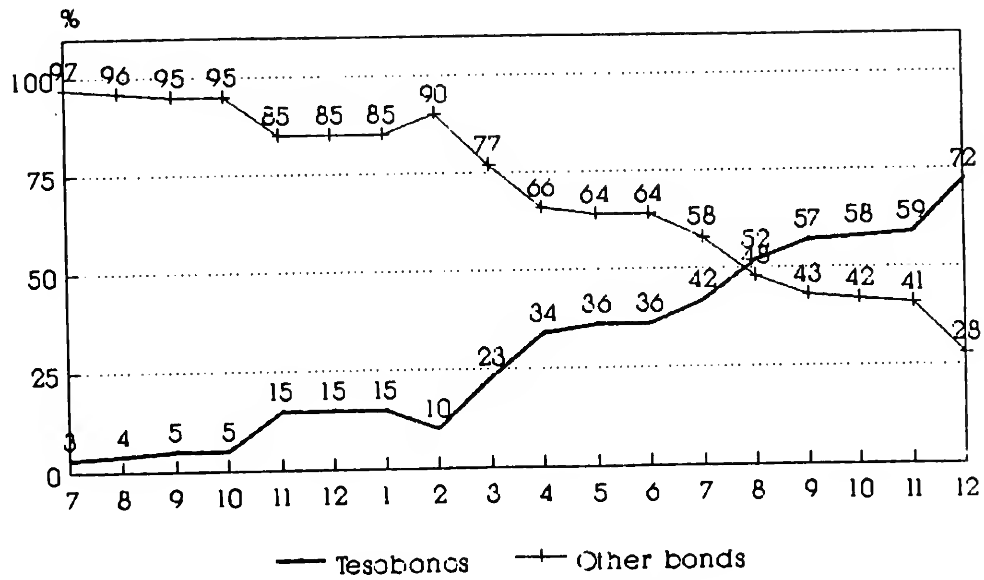
MEXICO, 1970-1994



Data Banco de Mexico. Casinol3

GRAPH 6

PARTICIPATION OF TESOBONOS IN TOTAL GOVERNMENT BONDS, MEXICO 7/93 TO 12/94



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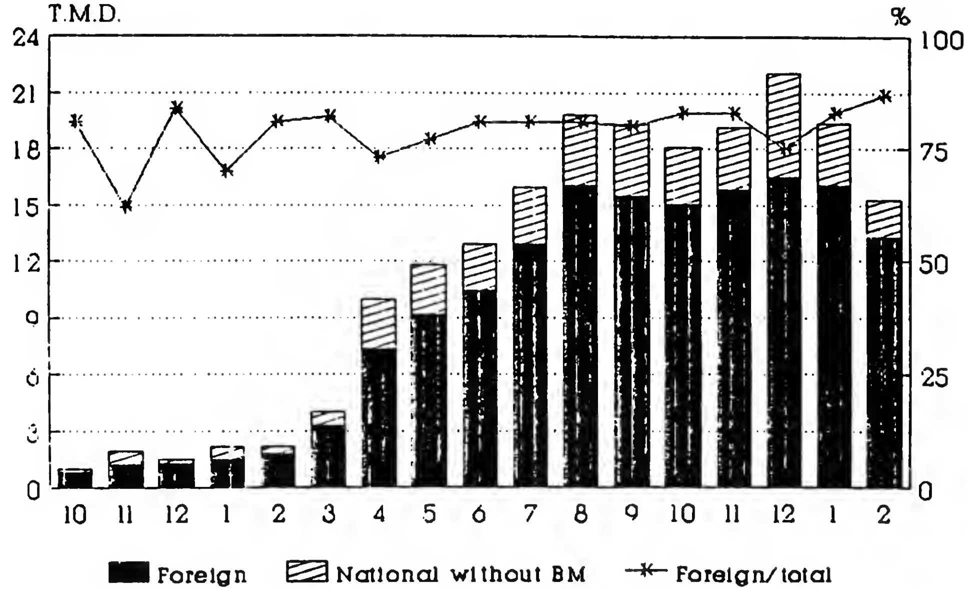
GRAPH 7

FOREIGN PARTICIPATION IN TESOBONOS

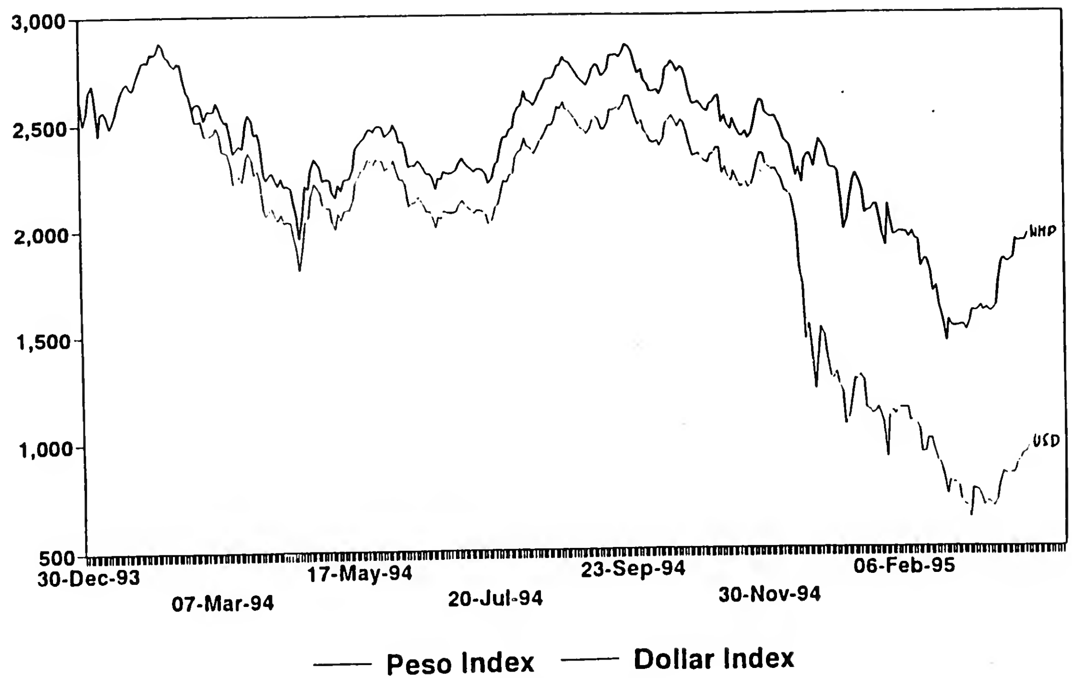
MEXICO, 10/93 TO 2/95



Data INVERMEXICO. Casino22

GRAPH 8A

Bolsa in Peso and Dollar Terms
Daily Data

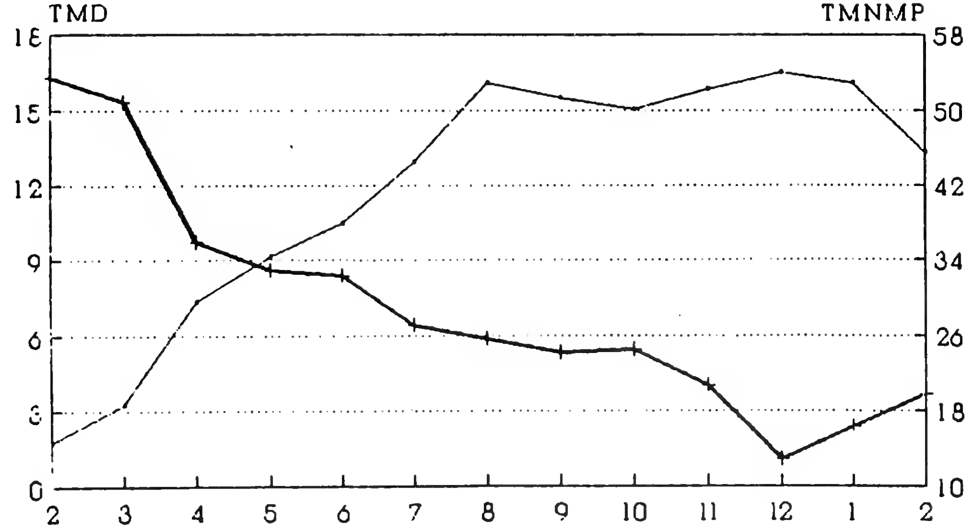


Source: INVERMEXICO

GRAPH 8B

FOREIGN INVESTMENT: CETES Y TESOBONOS

MEXICO, 2/94 TO 2/95

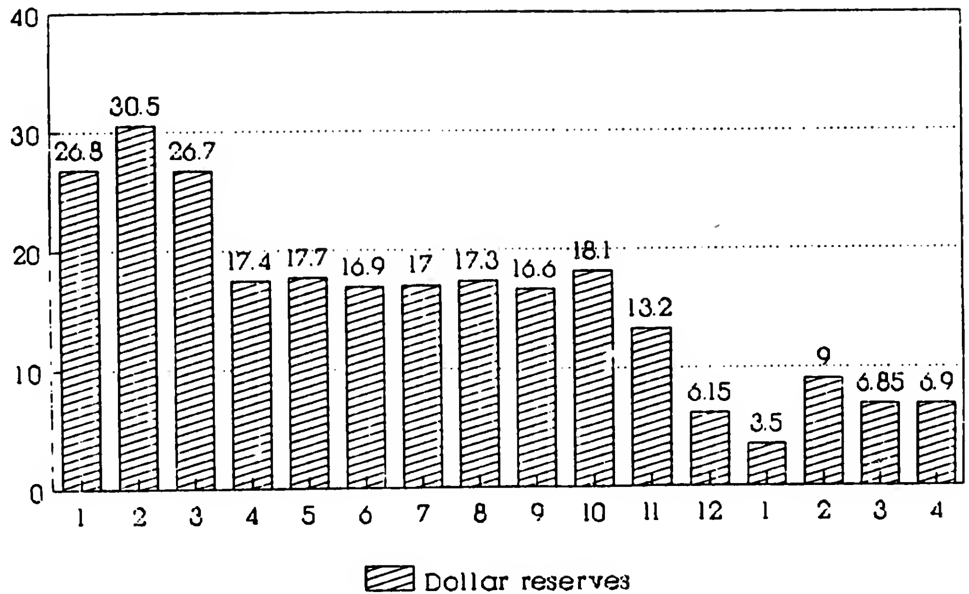


Data INVERMEXICO. Casino26

GRAPH 9

MONTHLY EVOLUTION OF DOLLAR RESERVES

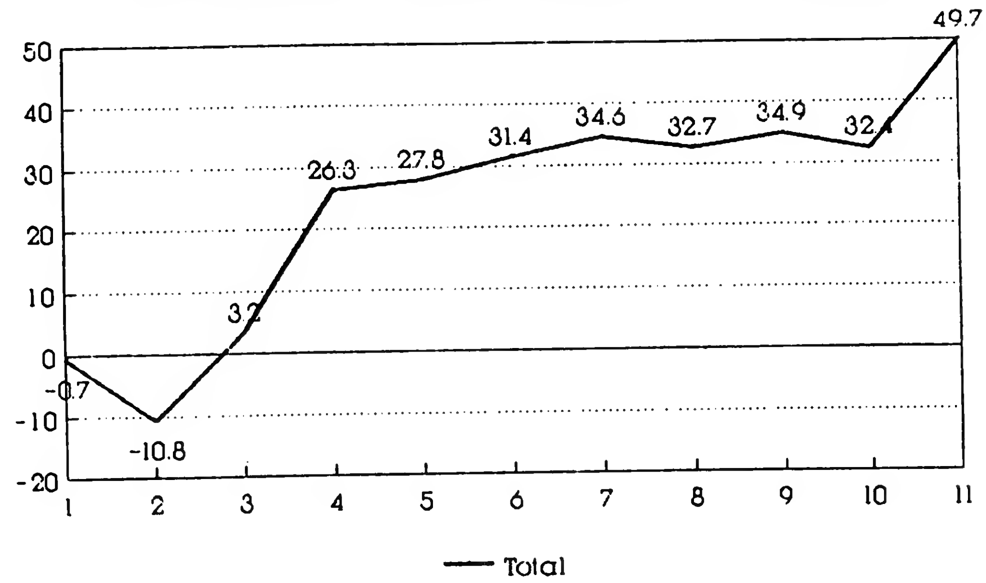
MEXICO,1/94 TO 4/95



Data Banco de Mexico. Casino-6

GRAPH 10

CENTRAL BANK'S TOTAL NET FINANCING IN MEXICO, 1994, BEFORE THE CRISIS

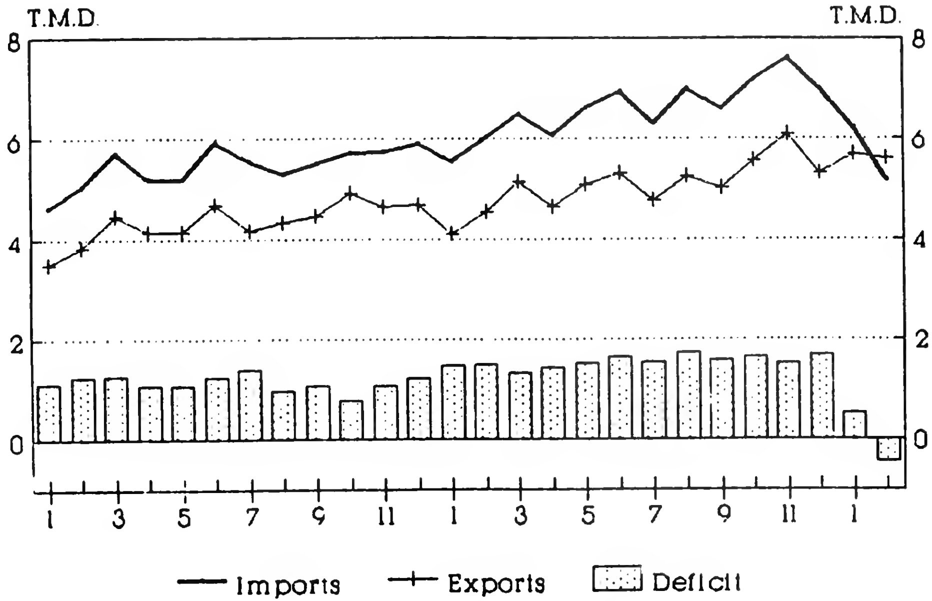


Central Bank's credit to government and banks. Casino27

GRAPH II

IMPORTS, EXPORTS AND TRADE DEFICIT

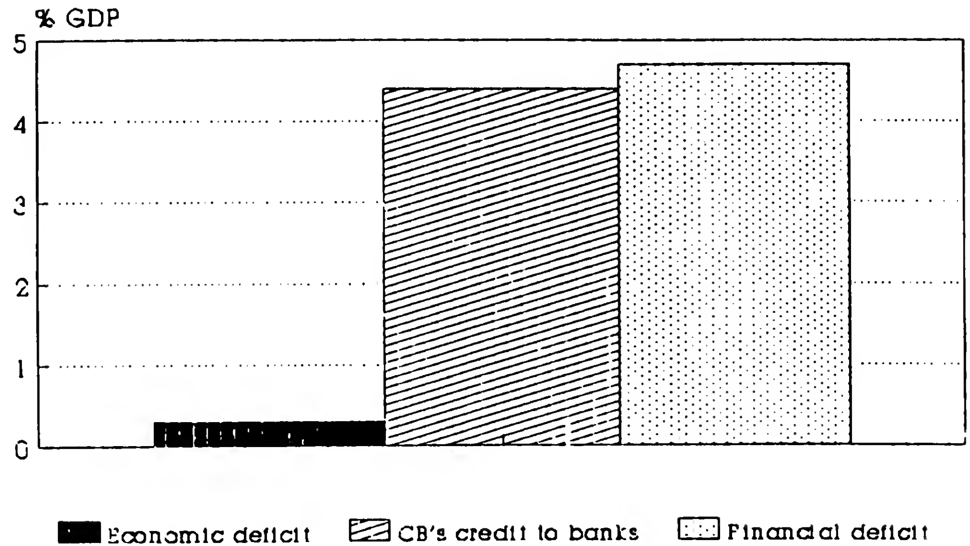
MEXICO, 1/93 TO 2/95



Data of Banco de Mexico. Casino24

GRAPH 12

FINANCIAL OR ECONOMIC DEFICIT OF THE FEDERAL GOVERNMENT, MEXICO, 1994



Financial deficit = economic deficit + CB's net financing of banks. Casino-6

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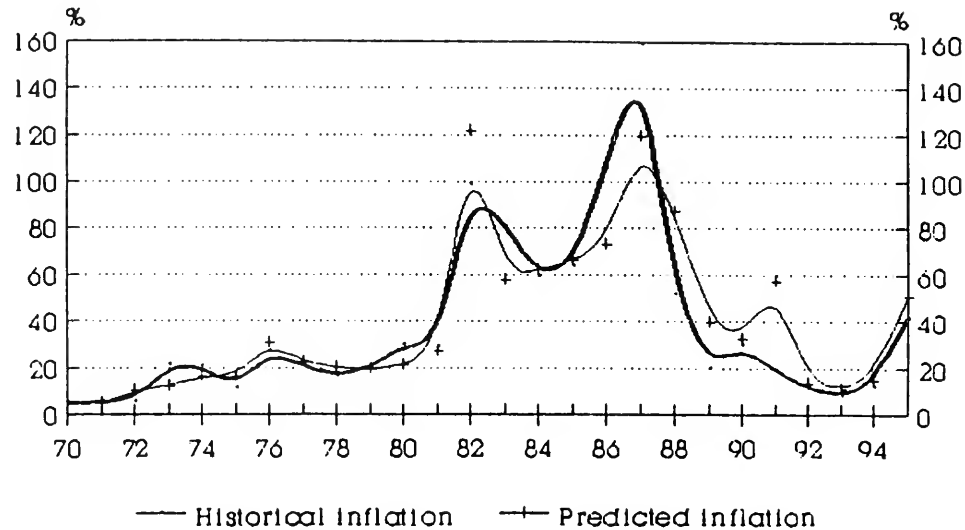
GRAPH 13

HISTORICAL INFLATION AND INFLATION PREDICTED BY ITS CAUSES, 1970-1995

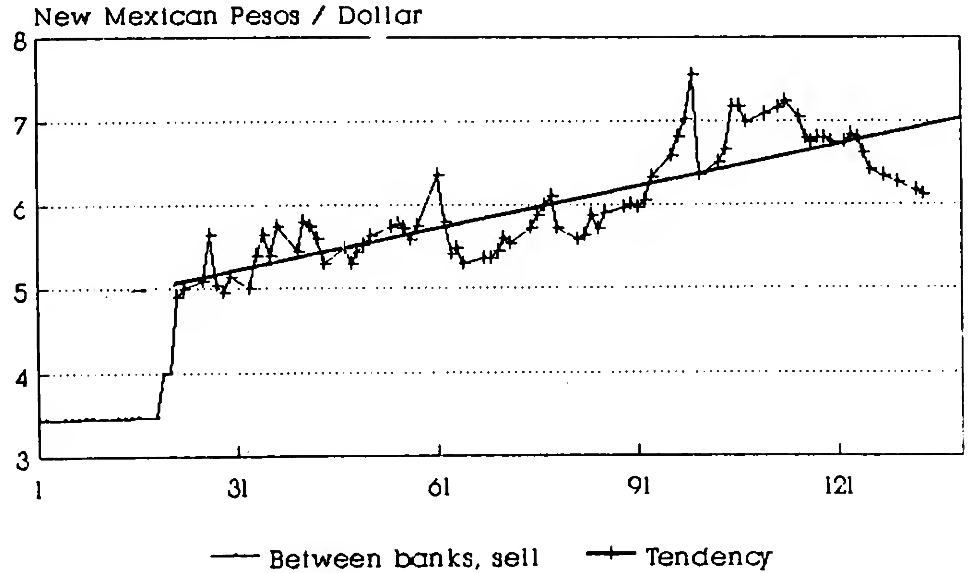


INFLATION= 0.40*(INERTIAL INFLATION)+
0.19*(DEVALUACION) + 0.37*(M1 VARIATION)
'asinol6

GRAPH 14A

EXCHANGE RATE BETWEEN BANKS

MEXICO 1/12/1994 A 12/4/1995

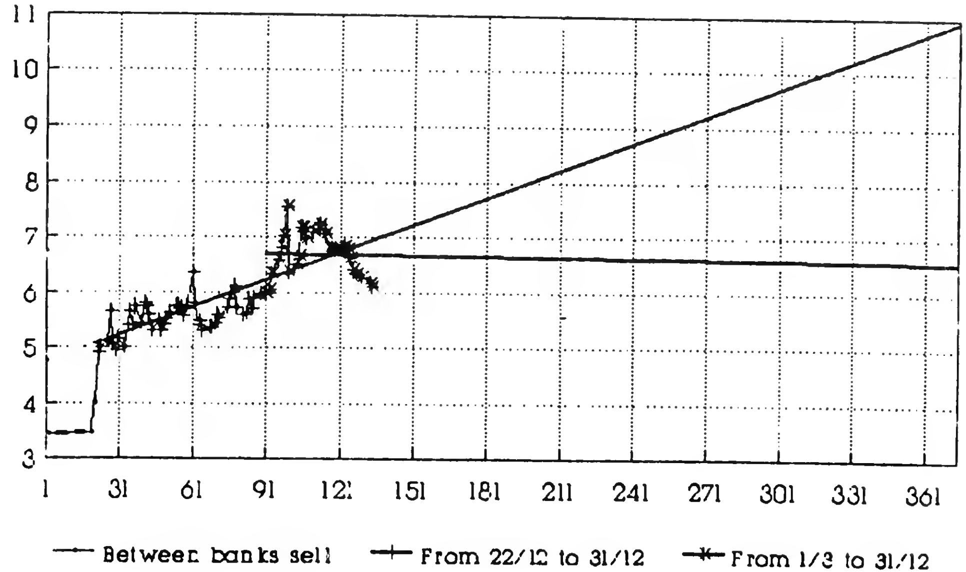


31/III/95 = day 121
14/IV/95 = day 136. Casino20

GRAPH 14 B

MEXICO'S FLOATING EXCHANGE RATE REGIME

ANNUAL TENDENCIES, 1/XII/94 A 31/XII/95

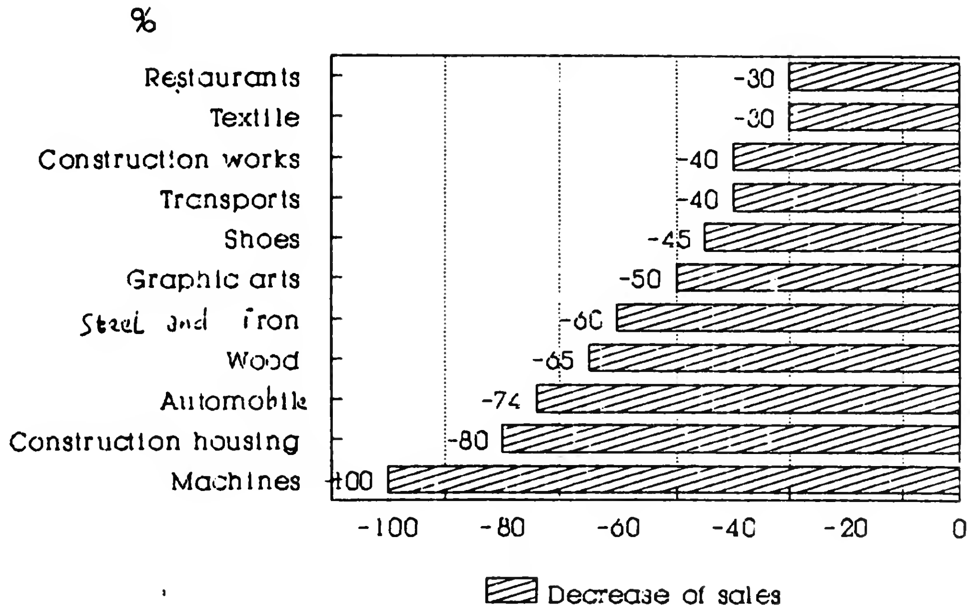


31 March = day 121
14 April = day 136. Casino21

GRAPH 15A

DECREASE OF SALES IN INDUSTRY

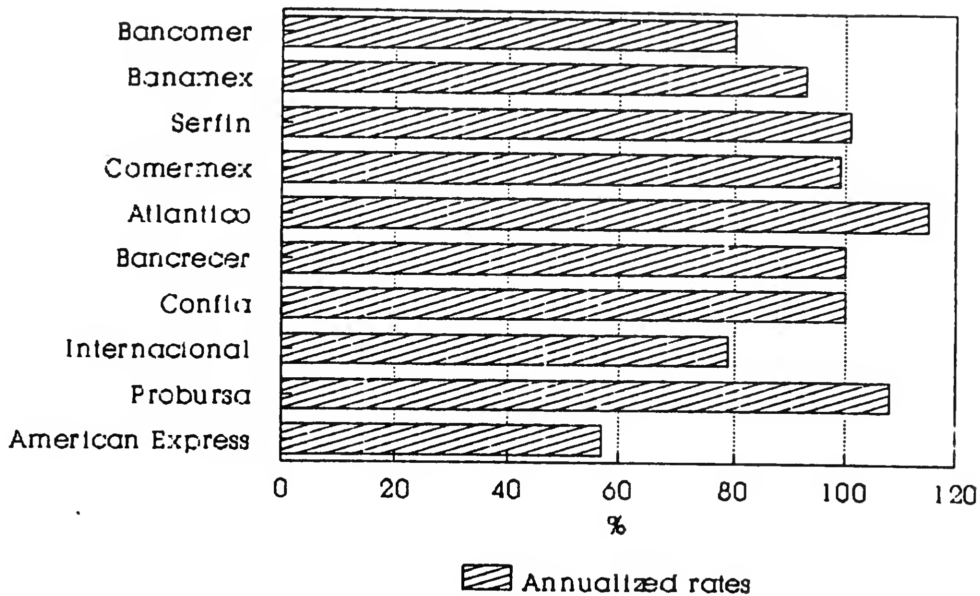
MEXICO, FIRST QUARTER OF 1995



GRAPH 15B

NOMINAL INTEREST RATES FOR CREDIT CARDS

MEXICO APRIL 1995



Data Mexican banks

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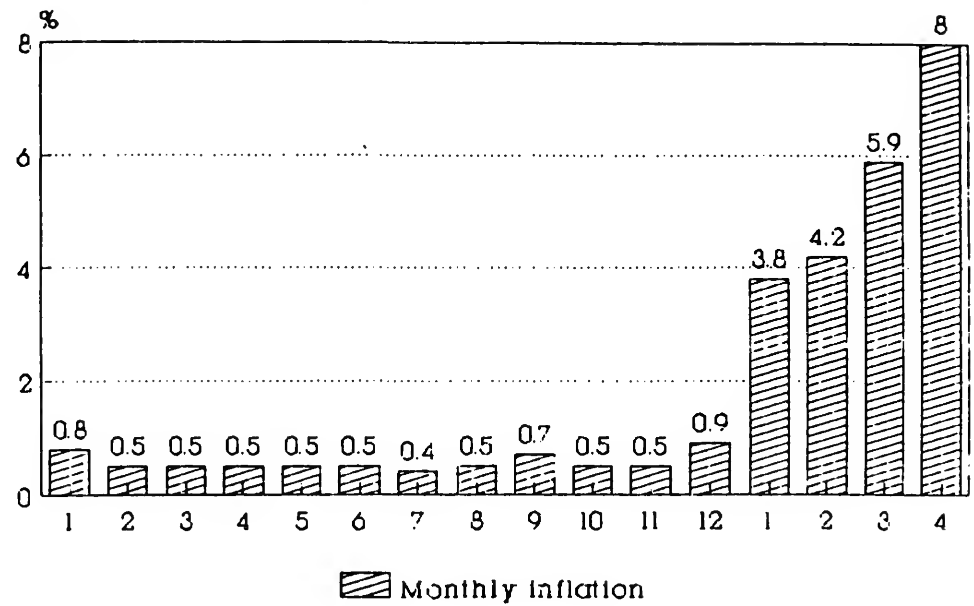
GRAPH 15C

MONTHLY INFLATION

MEXICO 1/94 TO 4/95



Data Banco de Mexico

PREPARED STATEMENT OF RAIMUNDO ARTIS

PRESIDENT, NATIONAL ASSOCIATION OF MANUFACTURERS (ANIT),
BUSINESS LEADER, MEXICO CITY, MEXICO

MAY 24, 1995

Dear sirs, to introduce ourselves let me say that our association was founded 8 years ago mainly to support the elementary right of freedom of association.

We have in Mexico a law called "Ley de camaras de industria y de comercio" in which it is stated that every enterprise has to be associated to one of the "Camaras." That law is against our Constitution that guarantees the freedom of association as the Supreme Court of Justice has failed in more than six cases up to now.

To understand the actual situation of the economy in Mexico it is necessary to clarify some points that were maintained obscures in order to have better public image for the government of Salinas, in Mexico and abroad.

The "structural change" of the Mexican economy never considered the evident following main causes of the recurrent monetary crises:

1. Plans and programs of government oriented to the short term. If the results or benefits will take a longer period of time than the government period of time, the issue is not even considered.
2. Overprotection to the:
   - financial system, such as banks, stockbrokers, etc.
   - monopolies, such as in copper, steel, and the telephone.
   - big multinational companies, such as automotive and food companies.
3. Inequality on taxes. Even the smallest enterprise pays 35 percent for the first N Peso earned. (That percentage is constant.)
4. Low return on investment for most public or private projects, as political or personal profit reasons are mandatory over economical or correct business reasons.
5. Weakness of the monetary system, as most of all decisions are politically oriented and not technically supported.
6. Illegal use of public resources for personal profit and abuse of privileged information.
7. Excess of monetary or liquid resources on the financial system which promotes speculative movements greater than normal.

At the same time, another significant problem for the productive sector during the Salinas years has been the interest rate charged by banks, which makes the bank business in Mexico one of the most profitable in the world. Along with the extraordinary overcharge, primary rate was always ranked high enough to attract speculative foreign capital. So from the point of view of industrial enterprises, interest rate is an unbeatable handicap for competition.

The lowest rate those years was 28 to 30 percent, and most of the time was higher than 38 percent, with inflation close to 7.5 percent.

Taxpayers paid generously for the whole banking system, after expropriation in 1982 of original owners, in less than 10 years. Users of banks paid the high price, paid for the new owners of the same banks, on resale to the private sector in less than 5 years.

Again, taxpayers are giving through the Hacienda (Treasury) quantities to the banks equivalents to their prices in most cases, to save them from bankruptcy due to devaluation and the related problems.

So the country paid the complete value of the banking system three times in less than 12 years.

After devaluation in December, banks increased interest rates to more than 110 percent, making unpayables most of the credits.

In the last 6 months, no new credits are authorized by banks. All credits are restructurations, so productive activity is at a minimum, and more than 800,000 workers lost their jobs in the last 3 months.

Last year, manufacturing companies closed operations and, as indicated, employment is today smaller than 10 years ago in this sector. Since December, this phenomenon has accelerated and, as the time passes, it is more difficult to restart operations and market is each day smaller.

It is evident for practically every trade association that there is imperative today a change in the policy which promotes immediately growth, as otherwise social explosions of unpredictable consequences may happen in a short time.

The government of Mr. Zedillo up to now seems to be following the wrong path followed by Mr. Salinas to give priority to inflation, rate of exchange, and financial equilibrium on government expenses over employment, growth, and other variables

reflecting the level of living of the population. Those indexes reflect the continuous lowering over 12 years in the standard of living of the majority of the people.

Equilibrium on government expenses is a priority, but the main problem is having nearly 4 million bureaucrats. That is what has to be reduced, not the basic investment.

To finish, I have not said a word about the big loan made available by President Clinton, the IMF, and others. There is a reason. That money is only used to change short-term credits ("Tesobonos") and, to some extent, to support losses in banks, but not a dollar is to promote growth, which is, we feel, the unique way to pay.

PREPARED STATEMENT OF JEROME I. LEVINSON, ESQ.

PROFESSOR, AMERICAN UNIVERSITY, RESEARCH ASSOCIATE, ECONOMIC POLICY INSTITUTE, FORMER GENERAL COUNSEL, INTER-AMERICAN DEVELOPMENT BANK, BETHESDA, MD

MAY 24, 1995

Thank you for your invitation to testify this morning on this important subject matter.

What is occurring in the Mexican banking sector must be understood within the context of the economic crisis that followed upon the devaluation of the Mexican peso on December 20, 1994. Beyond the specifics of that crisis, the basic issue for this Committee, it seems to me, is accountability, responsibility, and equity. Let me be more specific.

By now, the essentials of the situation are well known: Mexico in 1993–1994 was living well beyond its means, importing considerably more than it was earning through exports. The peso was overvalued, reflecting a burgeoning current account deficit approaching $23 billion in 1993. This deficit was being financed in large part by the issuance by the Mexican government of short-term bonds, Tesobonos, as they were called. These bonds paid a higher rate of interest than investors could obtain in more conventional international markets. They therefore attracted international investors seeking a higher return than could be obtained elsewhere, but they were also often investors who had no particular long-term interest in Mexican development and were relatively ignorant of Mexico's social and political conditions.

Interest rates rose, however, in the United States, reflecting a relatively strong U.S. economic recovery. A peasant uprising in the Mexican state of Chiapas and assassinations of important political figures created unease among investors as to the basic stability of the country. Doubts persisted as to whether Mexico could continue to finance its current account deficit. Investors increasingly liquidated their investments, rather than rolling them over into new debt instruments.

By late 1994, with financial reserves hemorrhaging daily, Mexico was unable to meet its international financial obligations. In January 1995, the Clinton Administration stepped in with a financial rescue plan for the Mexican economy, which had the support of the Republican leadership in both Houses of Congress.

The centerpiece of that plan was a $20 billion direct loan from the U.S. Treasury to Mexico and a $17.8 billion financial commitment from the International Monetary Fund (IMF). Funding from other sources was initially contemplated but either is increasingly doubtful or has not materialized.

What is so striking about this economic rescue program is how little it asks of the investors who originally were so eager to purchase Tesobonos for their high rates of return. This is in striking contrast with what transpired in 1982, when the Mexican finance minister appeared in Washington in August of that year and informed U.S. Treasury officials that Mexico could not meet its debt service obligations to private commercial banks from whom it had borrowed billions of dollars in the previous decade, thus setting off what became known as the debt crisis of the 1980's.

The then-Managing Director of the IMF, Jacques De Larosiere, set as a precondition for IMF participation in any financial package, a commitment by the commercial banks of continued financing, at least in amounts equal to the debt service obligations of the debtor countries. Public officials at various times tried to enhance this commitment to include net new financing, that is, lending in excess of debt service payments, with little success. And, finally, in 1989, after riots in Caracas convinced the Bush Administration that Latin America was a potential social and political tinderbox, the U.S. Treasury and the banks also accepted that debt reduction was a legitimate part of debt renegotiations between the debtor countries and

the commercial banks. However, fitfully, then, the principle that the lenders must contribute to a solution of the crisis was firmly implanted.

It is that principle—that the private financiers who had loaned or invested their money in search of higher returns must contribute to the solution of the problem—that was abandoned in the 1995 economic rescue plan proposed by the U.S. Treasury. The purchasers of the Mexican Tesobonos, wealthy Mexicans and American investors sufficiently affluent to invest in the high-flying emerging market funds which promised dazzling economic returns to their investors, were enabled by the U.S. and IMF loans to cash out their investments in dollars or dollar-equivalent value.

In my view, this was a mistake. It is true that investors in Tesobonos were a more diverse lot than were the private commercial banks in 1982. It is also true that these large banks, by and large, took a longer view of their interests in Mexico than the Tesobono type investor. But these differences do not justify the decision to abandon the principle that the financiers should, as in 1982, contribute to the solution of the problem.

Nor is it an answer to say that this was not feasible because of the diffuse nature of the investors. In one form or another, the investors still had to present their bonds to the Mexican authorities for redemption. They should have been told at that time that only some part of their investment could be immediately redeemed; the remainder would be offered to the investor as a new financial instrument paying an international market rate of interest and a maturity within some reasonable time (3 to 5 years).

The U.S. and IMF financial commitments have now been complemented by commitments by the World Bank and the Inter-American Development Bank (IDB) for several billions of dollars in loans to shore up the Mexican banking system. The Mexican banking system had been nationalized in the early 1980's, at the end of the Lopez Portillo Presidency, in part to end the incestuous relationship between major industrial groups and leading banks they controlled. President Carlos Salinas de Gortari, who assumed power in 1988, re-privatized those same banks. The private bidders for the banks included "some of the big bankers ousted by nationalizations here a decade ago." (Solis 1991.) The sale was intended to strengthen a "few groups of rich Mexicans before allowing foreign competition in the financial services sector. . . . [E]ven Salinas' most admiring supporters say the methods of bidding used tend to concentrate capital and replace government monopolies with private ones, rather than promote competition." (Dabrowski 1991.)

Again, what is so striking about the program is its bias in favor of the rich and powerful. Yet the ones who are bearing the brunt of the austerity program are the Mexican workers and the owners of small and medium enterprises. The latter are virtually cut off from credit as domestic Mexican interest rates have soared. Approximately 500,000 workers appear to have lost their jobs, and some estimates are that by yearend the number will reach one million. Those who remain employed have seen the value of their earnings decline by nearly 40 percent. Yet the earnings of the largely American-owned maquiladora factory operations on the border have soared, but the benefits are not being shared with the workers.

The *Washington Post* reports that the cleanup of environmental degradation that is endemic along the U.S.–Mexico border has ground to a halt because of the lack of financing: "Of particular concern to U.S. environmentalists are sewage-treatment projects in Tijuana, south of San Diego and Ciudad Juarez, south of El Paso, TX. Both cities house hundreds of American-owned assembly plants, whose presence has contributed to rapid environmental degradation as well as to a population explosion by Mexicans who migrated to the border in search of employment." (Robberson 1995.)

What do we have to say to the ordinary people who have seen their already precarious standard of living decimated? I have been the lead lawyer, on a pro bono basis, for the Mexican maquiladora workers of the Sony corporation. On behalf of those workers and under auspices of the nonprofit International Labor Rights Education and Research Fund (ILRERF), the American Friends Service Committee, and the Coalition for Justice on the Border, we initiated an action before the U.S. National Administrative Office established under the North American Agreement on Labor Cooperation (NAALC), which is the Labor parallel agreement to the North American Free Trade Agreement (NAFTA).

Without going into great detail, suffice it to say that the Sony Mexican workers wanted to select union leaders of their own choice in a free and fair election, an elementary assertion of the right of free association, a right nominally guaranteed by the Mexican constitution, labor law, and international commitments by the government of Mexico. Hearings were held in San Antonio, at which the Mexican workers gave eloquent testimony as to harassment by company officers and officials of

the existing union associated with the Mexican Confederation of Labor (CTM), which is closely associated with the governing party, the Institutional Revolutionary Party (PRI).

In a decision released on April 11, 1995, the U.S. NAO agreed that Mexican authorities had failed to enforce their own laws guaranteeing the right of free association by unjustly denying the request of the Sony workers for registration of an independent union.

The record in the Sony case is symptomatic of coercive labor practices that are pervasive on the Mexican side of the border in the maquiladora sector by American and foreign owned firms, like Sony. For the first time, the NAO recommended invocation of the consultation process of the NAALC, only to discover that there is no agreement on that process. Despite the specific findings of the U.S. NAO as to the failure of the Mexican government to assure the right of free association, to date there is no agreement with the Mexican authorities on a remedy.

The NAALC is a hollow agreement without effective sanctions, just as the *Washington Post* report has revealed the ineffectual nature of the environmental commitments under the NAFTA.

The net effect of the economic program is to (a) put the burden of adjustment on the Mexican workers without any assurance that at the end of the process they will be any further along in being able to have union representation that will bargain effectively on their behalf; (b) add to the concentration of economic power in Mexico by devastating the small and medium entrepreneurs; (c) accentuate the degradation of the environment along the border and ask nothing of the corporations that have contributed so much to that degradation; and (d) pour billions of dollars into Mexico to be used primarily to benefit affluent Mexican and U.S. Tesobono investors and the most powerful Mexican financial groups.

What I would urge this Committee to do is to return to first principles and ask the following questions: What is the purpose of the American-led financial rescue operation? Is it to restore the confidence of the same investors that bought the Tesobonos so that they will return to do the same thing? Is that the reason that nothing was asked of them in the January program? Does it make sense to impose a draconian economic austerity program to try to regain the confidence of the very same investors that did so much to contribute to the crisis?

Quite clearly the Mexican authorities have concluded that it is neither feasible nor desirable to pursue this objective. They are engaged on another strategy; to attract still more Foreign Direct Investment (FDI) for the purpose of producing goods and services for export, primarily to the United States. (Approximately 80 percent of Mexican exports are destined to the U.S. market; in some key sectors, like auto parts, the percentage is even higher.)

Can Mexico's renewed emphasis upon attracting FDI be reconciled with the labor and environmental parallel agreements to the NAFTA? Or is it likely to result in mere lip service to enforcement of those agreements, and has the Clinton Administration tacitly accepted that this is a necessary cost of the economic rescue program? Is this Mexican strategy viable over time, or will it create a backlash in the United States against a flood of Mexican exports produced by low-wage Mexican labor denied basic worker rights and produced under degraded environmental conditions?

We have tried various means of financing development in countries such as Mexico; commercial bank financing in the 1970's, which resulted in the debt crisis of the 1980's, and the emerging markets hustle of the 1990's, which led to the great Mexican bailout in January of this year. Now the Mexicans are launched on the great export/FDI push, which is almost certain to result in a bitter reopening of the NAFTA debate in the Presidential election campaign of 1996.

The common thread that runs throughout each of these schemes is the intervention of the U.S. Government on behalf of those most responsible for the difficulty, the commercial banks in 1982 and thereafter and Tesobono investors in January of 1995. At the same time, ordinary people, who are least responsible for the crisis, are asked for the greatest sacrifice. The pattern is about to be repeated as Mexico desperately tries to export its way out of the latest fiasco. American workers will pay the price in a net loss of jobs, directly contrary to what was promised them in the NAFTA debate, as the United States runs an estimated $15–$18 billion trade deficit with Mexico. And Mexican workers will pay an even more fearsome price in the loss of jobs and decline yet again of living standards.

What we need is a reconsideration of traditional assumptions concerning what we are about in countries like Mexico and how we balance the various interests in both American and Mexican society. As it is, we are now launched on a journey without a clear destination, analysis of what went wrong, or road map of how to correct the course. Your hearings can be a beginning in redefining American thinking on these important issues.

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EMERGING MARKETS

MORGAN GRENFELL

May 4, 1995

Mexican Banking Update

Recommendation

1Q95 results have just been published. Here is our updated trading call. After the recent rally we have changed our **Buy** recommendation on Bancomer to **Hold**. We continue to recommend a **Sell** on Banacci and Serfin and a **Hold** on GFNorte

MEXICO: *"LINDO Y QUERIDO"** OR HOW TO RAISE YOUR SALARY

Mexican banks are releasing 1Q95 results and are showing a decline in earnings of between 15% and 70% Many investors and journalists have taken these figures as a sign that banks are not in such bad shape as previously thought. Bank stocks have recovered significantly from their early March levels. In our view, however, 1Q95 results are partially a product of creative accounting and investors should be cautious.

Bank analysts should, however, take this opportunity to ask for a salary increase, since the job from now on will be increasingly difficult For example consider the case of Serfin. The bank reported 1Q95 net result of NPesos 208 million vs NPesos 246 million in 1Q94. Now, some might say that this 15% drop is not bad considering the current environment If you tell your boss that Serfin's comparable figure for 1Q95 should be NPesos 2 2 billion loss, he might offer to buy you a new calculator. (After all, how else can you explain such a discrepancy)

Our suggestion would be to ask for a raise rather than a new calculator because now you have got a lot more work to do Besides, your old calculator still works! Lets start our analysis with a vocabulary lesson

UDI'S: A new currency in which to convert bad loans. This currency unit, which is pegged to inflation rate, reduces interest payments but increases principal payments Furthermore, loans are transferred into an off-balance sheet trust (so they are forgotten about for a few years)

Procapte: The extensively advertised, temporary capitalization program. A way of channeling funds from the government into the weaker banks

Net Interest Margin: The key word is "accrued." Not everything accounted for will become cash Watch out for Banamex's surprising accounting change on certain mortgage loans

Provisions: Houdini is still alive and well. He is working in the accounting & reporting department of Mexican banks Provisions not shown in the P&L account is the preferred accounting trick being used to turn bad into good

Non-Performing Loans: Crisis, what crisis? Beware of roll-overs and "ever green loans "

Capitalization: Killing two birds with one stone. A peso used to make provisions for B & C loans can also be accounted as Tier II capital

* *"Beautiful and Loved"*

Alberto Sanchez
(212) 468-5570

GRENFELL
EMERGING
MARKETS

UDI's

Unidades de Inversión, copied from Chile's Unidades de Fomento, should be treated as a new currency that appreciates vs the peso as much as inflation. It might be easier for you to call it ECU instead of UDI. Whenever we mention UDI write ECU instead and it should help you.

The UDI is a currency with a much lower nominal rate than the peso (lets say 5% vs 75%) although its value appreciates constantly against the peso. If you convert your debts to UDIs your interest payment drops dramatically, although the principal increases as its value appreciates, and in the end you'll make a huge balloon payment.

The good part of the story is that this might save a lot of viable businesses that have short term liquidity problems. They can be saved as long as they can generate earnings at a higher rate than the UDI's appreciation (= inflation) to make the balloon payment. The plan is to create UDI's roughly equivalent to 15% of the banking system's total loans, so banks should be able to convert most of their small and medium sized problematic loans into this category. For large loans it is always easier to reschedule on a one by one basis.

The bad part of the UDI program is that it is just postponing a problem; setting it aside for a while in a trust which is off the balance sheet. Banks will have to provide a reserve of 15% for the loans transferred to the trust, which is significantly lower than what they are reserving today for past dues (60%). Banks are even entitled to charge up to a 3% management fee for managing this trust of former loans, isn't it great? You say bye-bye to the bad loans, strengthen the balance sheet and even charge a fee for doing what you were supposed to do anyway. Forget about seeing consolidated statements, it did not happen in the good years, and it is not going to happen now.

Procapte

Procapte is a temporary capitalization program. Banks that do not meet the 8% minimum capital ratio requirement have to issue subordinated debt that is then bought by the government. Banks can repurchase that debt, but if they do not do so the government will convert it into stock, becoming a shareholder.

Net Interest Income

Some banks have shown impressive increases in net interest income vs 4Q94 figures (Bancomer +37.5%, Banamex +65.6%, and especially Banorte +85.7%). The positive side is that this is a reflection of flight to quality and a high proportion of deposit funding as opposed to interbank funding (which is why Serfin's net interest margin dropped 22.6% in the same period).

However, according to the accounting principles that most banks enlist, net margin comprises the accrued interest income minus accrued interest expense. "Accrued" is the key word. It roughly means that you are accounting for income when earned and expenses when incurred, regardless of when the cash is received or disbursed. Looking at the two sides of the equation, the expense side (usually to depositors) is, for the bank, as certain as death and taxes. However, on the income side, given the current environment, *we have big doubts that all these accruals will become real cash*. In other words accruing interest on credit cards at a rate of 100% might be a nice accounting exercise and might look good in the income statement, but it is very likely that you will have to reverse these accruals and charge a provision when the customer does not pay you. Remember that some banks wait up to 270 days until credit card loans in past due are declared non-performing. Thus we have big reservations about interest income and margins.

Furthermore, Banamex made additional adjustments to its interest margin. The bank decided this quarter to recognize interest accrued on the "Espacios" mortgage loans (although they are unpaid on a cash basis). This is significant, since it represents a net addition of NPesos 1.7 bn to the income statement, when the 1Q95 net income figure is NPesos 686 million. The main reasons given were that all other Mexican banks do it and that they needed it in order to subsequently convert these loans into UDIs. These are all legitimate reasons, however, we feel that the extra premium that investors paid for Banamex stock due to its conservative accounting practices has suffered significantly.

Analyzing 1Q95 results becomes even more tricky when considering that this extra NP 1 7 bn is an accounting item and if excluded, Banamex's bottom line would show a NPesos 987 million loss

Provisions

We have seen some Mexican banks going back to their one time favorite sport That is charging provisions for loan losses directly to equity without showing them in the profit and loss account The main reason given Banks do not get a tax credit for showing these losses But when one sees Serfin's 1Q95 results of NPesos 208 million compared to NPesos 246 million in 1Q94 and realizes that the figure to be used in 1Q95 is really a NPesos 2 18 billion loss, doubts fly over other released data too.

Banco Mercantil del Norte (Banorte) also showed a 1Q95 net profit of NPesos 71 3 million compared to NPesos 81 5 million a year earlier In 1Q95 a provision of NPesos 128 million is not shown in the income statement so the comparable figure should be a NPesos 57 million loss At least Banorte showed 73% of the provisions realized in the quarter in the income statement. Serfin showed 0%.

Of course, P/E multiples and especially ROE are completely distorted because of this practice ROE looks great since earnings are boosted and capital reduced (guess the first ratio shown by Serfin in its first table in the press release). P/Es are also misleading because they might show that the bank is actually a lot cheaper than it really is We recommend focusing on price/book value multiples for comparative analysis Some distortions exist, but it is a more reliable multiple in these circumstances.

Non Performing Loans

Most banks show increases in these accounts but be aware of loan rollover ("ever green" loans or "prestamos de barra libre" as they say in Spanish). For example, you owe 100 Pesos at a 15% rate to a Mexican bank You are not able to pay the 115 pesos at maturity The bank then extends a new 115 pesos loan, this time to a subsidiary with a different name, so CNB inspectors are not suspicious The original loan is repaid and classified as perfectly performing This is a regular practice in many countries, not only Mexico, and of course there are legitimate rollovers, usually for working capital purposes

How can you identify this in a bank's accounts? It is very difficult, almost impossible in fact. One sign is usually the increase in overdrafts used by companies to pay interest on other loans (this practice leaves the loans as performing and increases the net interest margin because of the high rates of overdrafts), but you will very rarely have that information available How long can a bank maintain this situation? In the case of Mexican banks they can extend this situation with no problems until the UDI's are implemented Otherwise we reckon that with current interest rates and a recessionary environment, it won't be possible to do this on a large scale for more than a year It took Bank of Spain 6 years to discover that Banesto was doing it with USD 4 billion, although the Spanish economy was booming Bank of France is still discovering the size of it at Credit Lyonnais

In any case, most non-performing loans will disappear from the balance sheet once they are transferred to the UDI trust, and we ignore the level of information banks will provide of the performance of such loans in the future

Capitalization

Be aware that in Mexico, provisions for "B" and "C" loans can be used as Tier II capital Some banks, notably Banorte, dramatically increased the loans in the "B" category (from 21 7% to 62 1% of total loans) Although it is a conservative move, investors should also be aware that the bank is also increasing its Tier II (supplemental) capital ratio We do not have doubts about the sound accounting practices of Banorte, but we know other banks held in the "C" category loans to companies like Aeromexico, and are using the provisions assigned to these "C" loans to increase capitalization ratios "Kill two regulations with one peso"

In addition, be aware of important asset revaluations that might lead to significant increases in capital Some of them are legitimate due to foreign exchange earnings, but market values today in Mexico of a lot of these assets must be significantly depressed, so revaluations based on inflation might lead to disparities

GRENFELL
EMERGING
MARKETS

Conclusion

We hope this quick list will be useful in analyzing the results of the banks that have not yet been released We recommend focusing on Price/Book multiples which should be less distorted than P/E multiples

GFBancomer: Overall we were pleased by the way they presented the results and by the general core earnings trend A lot more provisioning is needed but that's already built into the price We recommended in our February banking update to buy the bank below 35% of Book value (that is roughly a price of NPesos 1 00/GFBc) After falling to 33% of book value, the bank jumped to a multiple of 63 6% of book value or NPesos 1.81 in this period. We downgrade the bank to a **Hold** at these levels (between 50-60% of book value).

Banacci: As mentioned earlier, the bank has lost part of its aura of conservative bank accounting after its new treatment of mortgage loans We see no reason to pay the current 119% of book value We reiterate our **Sell** recommendation

GFNorte: We still like the management and regard the bank as one of the best in Mexico Its market share in Monterey keeps rising (its up to 33% now from 18% a few months ago), and its ratios continue to be the among the best in the system. However, at 143% of book we recommend a **Hold** Buy if the price falls below 100% of book value (6 NPesos per GFBc share)

Serfin: **Sell** is reiterated The huge provisions that the bank made (not shown in the income statement) are a sign of the depth of their problems A lot more provisioning is still needed

PREPARED STATEMENT OF DR. BERNARD L. WEINSTEIN

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MAY 24, 1995

Last year Mexico ran down its foreign currency reserves from $25 billion to near zero in a futile effort to maintain the value of its overpriced peso. Though the factors leading up to this run on the peso were many and complex, three general explanations can be offered: (1) Since 1994 was an election year in Mexico, the ruling party (PRI) was reluctant to contract the money supply and devalue the peso gradually for fear of losing popular support; (2) From 1991 to 1993, foreign lenders loaned Mexican enterprises $15 to $20 billion a year more than Mexico was earning from its exports; and (3) Wall Street's lending to Mexico helped to precipitate the crisis since the bulk of American investment was of the liquid portfolio variety as opposed to direct investment in Mexican companies.

By now, the consequences of the peso's collapse have been well-documented. The noted Mexican professor, columnist, and author, Jorge Castaneda, recently asserted that Mexico is in the midst of a "meltdown"—his metaphor for the country's "falling apart" due to the turbulent economic, political, and social conditions there. Though Professor Castaneda is often given to hyperbole, his views certainly appear to be on target when it comes to the current state of the Mexican economy and, particularly, its banking system.

At best, Mexico is in the initial stages of a very severe recession that may well last for several years. At worst, Mexico may be entering a prolonged period of economic and social unrest accompanied by dramatic political change. The following statistics suggest how serious the economic fallout from the collapse of the peso has become:

- Since late December, the peso has fallen 40 percent against the U.S. dollar and the value of securities traded on the Mexican *bolsa* has dropped 32 percent.
- Interest rates were high before the peso crisis—35 to 40 percent. Today, it is not uncommon to find banks charging 80 percent on mortgages, 100 percent on personal loans, and 120 percent on credit cards. And the situation is exacerbated by the fact that virtually all consumer lending in Mexico is based on variable rates.
- Because of the spike in interest rates, many state and local governments in Mexico are having difficulties meeting their debt obligations. Much like Orange County, California, some of these subnational governments may be forced into bankruptcy. (Of course, Orange County has the resident income and fiscal capacity to bail itself out while states and municipalities in Mexico don't).
- Mexico's Gross Domestic Product (GDP) is officially forecast to drop 3 percent in 1995; but private forecasters expect the decline to be much greater, perhaps as much as 10 percent.
- Inflation, which was held to a modest 5 percent in 1994, is currently running at 50 percent and could go even higher as workers demand higher wages to compensate for the loss of purchasing power.
- Although the official unemployment rate is currently at about 6 percent, private economists estimate the true unemployment rate at closer to 15 percent. Middle-class Mexicans have been hit hardest by the recession, with more than one-half million engineers, managers, accountants, bankers, and other professionals losing their jobs in recent months. In effect, the peso devaluation has brought about the disenfranchisement of Mexico's rapidly growing middle class.
- Despite a 25 percent jump in exports since the beginning of the year—one of the few positive developments from the peso devaluation—Mexico's manufacturing capacity utilization rate has dropped from 90 percent to 60 percent. Of course, what's positive for Mexico is often negative for the United States. Last year, Mexico was one of the few countries with which we ran a sizable trade surplus. This year, that surplus will likely become a $15 billion deficit, putting Mexico third behind Japan and China.
- Retail trade along the U.S. border with Mexico has dropped 30 to 80 percent in 1995, depending on the city, and total detentions of illegal immigrants are up 40 percent from a year ago.

Because of dramatically higher interest rates, rising unemployment, and a growing number of business contractions and bankruptcies, Mexico's banking system is under tremendous stress. Obviously, many households and companies are unable to make their loan payments on time in the face of falling incomes and rising interest costs. Before the collapse of the peso last December, past-due loans were approach-

ing 10 percent of total loans in the banking system. Today, that figure is closer to 20 percent, and two large banks have failed so far in 1995. Indeed, it appears that many banks will have difficulty this year retaining enough funds to meet the government's capital requirement of 8 percent of assets. What's more, Mexico's historically low savings rate coupled with a devalued peso and a rising cost of living make an inflow of domestic funds to the banking system highly unlikely in the foreseeable future, despite record-high interest rates being offered to depositors.

In some ways, Mexico's current financial emergency mirrors Texas' and then America's S&L crisis of a decade ago. An inadequate capital base, rising loan losses, inexperienced management, and a sky-high cost of funds all sound familiar. In response, the Mexican government has taken over some institutions and separated out the good loans from the bad loans, just as we did here. In addition, Mexico is talking about allowing foreign banks to gain 100-percent control of weak and failing domestic institutions, just as New York, North Carolina, California, and Ohio banks took over all of Texas' large financial institutions in the late 1980's—with the assistance of the American taxpayer. The prospect of American bankers controlling Mexican capital has raised nationalist protests, but the ruling party and Mexico's bankers recognize there's no hope for their financial institutions without an infusion of foreign cash.

What's likely to happen in the weeks and months ahead? Will an additional U.S.-assisted bailout be required or requested, beyond the $20 billion already pledged? There are other members of this and the following panel with expertise in international finance who are better qualified than I to answer this question, but it seems to me additional American assistance to shore up Mexico's banking system is inevitable since most of the initial funds have already been committed. Approximately $16 billion of Mexico's current short-term debt is owed to American individuals and institutions, and the February agreement will make those lenders whole. But if American banks are to increase their investments and exposure in Mexico as part of a global recovery effort, they will surely require additional loan guarantees from Washington or the International Monetary Fund.

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Hearings Before the Committee on
Banking, Housing and Urban Affairs
United States Senate

May 24, 1995

NATIONAL CELEBRATION

"The commercial balance improves!"

Summary

◆ Because of many factors, including the December 1994 peso devaluation, the productive sector of the Mexican economy is undergoing a severe contraction and *deflation*, a process that has seen one out of every three companies closed and hundreds of thousands of jobs lost. When stock market analysts and/or members of the Clinton Administration says that the Mexican economy is "recovering," what they mean is that the speculative sector is stable. Unfortunately, this has little immediate or even long-term benefit for or impact on the productive sector where the majority of people live and the income to service Mexico's foreign debt must be generated.

◆ The economic policies of Carlos Salinas emphasized the sale of state run companies and the raising billions of dollars in new foreign debt rather than boosting exports and job growth. The result is an economy that has more debt ($150 billion plus) and arguably less ability to generate *dollar* income than it did in 1989. Moreover, as the productive economy has suffered, more and more people in cities and on the land are reluctantly turning to immigration, speculation or illegal activities in order to just survive, much less earn a living.

◆ It is impossible to have sound, solvent banks in an economic environment that is as hostile and difficult as the one that I have just described. Mexico's banks remain deeply insolvent, no matter what local regulators, bankers and politicians say to the contrary. Most Mexican banks are bankrupt because large proportions of their customers have lost businesses and/or jobs, and are in default on a variety of financial obligations. The National Coordinator for Bank Customers (CNUB) estimates that 70 percent of consumers have serious financial difficulties. Another estimate claims that as many as 4 million credit cards are in default in Mexico, more than half of the total outstanding.

◆ The illegal sector is by far the largest of the three sectors of the Mexican economy, which is built around narcotics trafficking, arms smuggling, kidnapping and other forms of illicit activity. The criminal economy in Mexico has mushroomed in size over the past decade and now clearly dominates the entire political economy of Mexico. By way of comparison, consider that the $25-30 billion in profits from the $100 plus billion-per-year narcotics trade is twice the total *revenues* of the Mexican oil sector. Mexico's banking system is increasingly dependent on the cash flow generated by drugs for liquidity, thus making it even more difficult to address the problems of corruption and money laundering. Today, drug traffickers in Colombia and Mexico are united in an unholy transnational business alliance that in financial terms rivals the largest corporations in the world. This burgeoning "criminal capitalism" is a direct threat to the national security of the United States. [1]

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[1] See Puig, Carlos, "Como empresarios modernos, los capos de Cali y los narcos mexicanos dejan de competir y se unen en una poderosa alianza estrategica " *Proceso*, May 8, 1995, pp.14-19

Mr. Chairman:

Thank you for asking me to appear before the Committee. Today I will provide you with a general assessment of the impact of the December 1994 devaluation of the Mexican peso on the banking system and the economy of our southern neighbor. To do this in a way that is succinct and clear, below I provide a summary of the present economic and financial situation in outline form. I have also taken the liberty of including cartoons from the Mexican press. In authoritarian countries, a grouping that unfortunately includes Mexico, artists and satirists often best present the reality that underlies a given situation in politics or business.

The Economy

It is useful to think about Mexico as being comprised of three spheres or sectors of economic activity: the productive sector, the speculative sector and the criminal sector.[2] Let's consider the results of six years of economic "reform" under Carlos Salinas de Gortari, a process that really culminates with the collapse of the peso in December 1994:

1. The productive economy, excluding the in-bond or *maquiladora* sector, has shrunk in terms of the total number of jobs and private sector companies, both over the past 6 years and especially since December of 1994.[3] The most recent and well-publicized losses of businesses and jobs are only a continuation of the generally dismal results of the Salinas *sexenio*, when taxes were increased sharply, exports were stifled by an overvalued currency and governmental corruption reached new heights. Dislocation among different industries and in rural areas of Mexico has been massive over the past six years, resulting in literally millions of families being driven from their homes or from the land and into the streets of already crowded Mexican cities, a rising flow of desperate people who must eventually move north. Consider some basic indicators:

- The Confederation of Merchants and Service Providers reports that one of three businesses in Mexico has closed since the start of the peso crisis in December.[4] They add that a good portion of those firms that have resisted closure are living "on the edge of failure." According to Concanaco, the Mexican equivalent of the U.S. chambers of commerce, 40 percent of all

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[2] I owe a debt of gratitude to Mr. Eduardo Valle for this tripartite concept. *Gracias amigo!*

[3] Employment in the *maquiladora* sector reached 550,000 by the end of 1994, although these facilities are almost exclusively used for export and contribute little to the local economy. For example, with the in-bond sector, Mexican gross manufactured exports in the first 10 months of 1994 were $41.485 billion, but excluding the *maquiladoras* drops the figure down to $20 billion, including oil exports. The in-bond *maquiladora* sector generated $26.3 billion in exports last year vs imports of $20.5 billion, for a gross value-added of $5.8 billion. See *El Financiero*, February 3, 1995, p. 28A.

[4] See "Por la crisis ha cerrado uno de cada 3 comercios," *La Jornada*, May 4, 1995, pg. 40.

Mexican firms in existence last December could close by the end of 1995.[5] Government officials have publicly acknowledged that as many as 750,000 jobs may have been lost in Mexico since the start of 1995. Over the past 12 years, the Mexican textile industry has lost 50,000 jobs, imports of apparel have pushed Mexico's textile deficit up 661 percent to $1.5 billion last year, and 600 textile producers have closed. In the plastic container industry, nearly 60,000 jobs have been lost in the past 8 months as scores of private producers have been crushed by sharply higher prices and falling domestic sales.

◆ Used car sales, a key indicator of the state of the private economy, have fallen by more than 50 percent in the first several months of this year. Officially, past due payments on auto loans are running at about 40 percent of total credits, which at the start of 1995 carried a *monthly* rate of interest of 5 percent or 60 percent annually. New car sales in April were down 80 percent from levels of the same period a year before. Prices for some new vehicles have been raised as much as four times since the start of 1995.

◆ Claims by the government of Ernesto Zedillo about a positive balance of trade are suspect, at least until such time as the detailed, ex-*maquiladora* figures are available (see table below). Overall, Mexico's manufacturing sector remains slightly in deficit despite a sharp drop in imports. In April, total "gross" manufactured exports were $4.6 billion, but this figure falls to only $2.58 billion when transactions from the in-bond, *maquiladora* sector are excluded from the calculations.

Commercial Balance
(millions of dollars)

	1994	Jan-Feb 94	Jan-Feb 95	Var %
Gross Balance	**-13,480.60**	**-2,966.60**	**-295.20**	**-90.00**
Maquiladoras	5,410.60	557.50	224.70	-59.70
Domestic	-18,890.60	-3,524.10	-520.00	-85.20
Total Exports	**60,833.40**	**8,621.00**	**11,527.00**	**33.70**
Petroleum	7,393.20	986.80	1,310.20	32.80
Non-Oil Exports	53,440.20	7,634.20	10,216.80	33.80
Total Imports	**79,734.90**	**11,587.60**	**11,822.20**	**02.00**

Source: Hacienda

◆ In addition to concerns about the distorting effect of *maquiladora* transactions on Mexico's trade balance, I am very dubious of official claims of the prospects for an overall payments surplus given Mexico's huge debt service costs

[5] See Munoz Rios, Patricia, "Podria cerrar 40% de los comercios del pais en 95, advierte Concanaco," *La Jornada*, May 9, 1995, pp 41.

for 1995. Payments on Mexico's $150 billion or more in public and private foreign debt could exceed $30 billion this year, not including redemption of *Cetes* and *Tesobonos* which are subject to the U.S.-engineered bailout. To put it another way, the payments needed to service Mexico's foreign debt roughly approximate the likely "net," ex-*maquiladora* exports for the entire year.

◆ For the same reasons that give me concern about the situation with respect to the external deficit, I am also very wary of optimistic statements concerning the internal fiscal situation. The Salinas government deliberately concealed a considerable budget shortfall in 1994 and this year's situation is going to be far worse. The Zedillo government claims that it generated a fiscal surplus of N$8.99 billion in the first quarter of 1995, excluding $9.49 billion in fixed debt service costs and $13 billion advanced to Mexico under the Clinton bailout program (which requires a 9 percent reduction in government spending). Yet total government revenues fell over 20 percent in real terms between the start of 1995 and the end of March.[6] Total revenues collected in the January-March period reached N$23.305 billion compared with N$25.283 billion in the first quarter of 1994. As the internal economy contracts through 1995 and beyond, tax revenues are likewise going to continue to fall due to declining employment in the public and private arena, and the closures of literally thousands of private companies.

The *deflation* visible in Mexico is part of a larger, global asset and revenue collapse that is apparent in Japan, China, Europe and in many emerging markets. High real interest rates and confiscatory taxation have made it impossible to support most types of productive, legal business activity in Mexico. Like Venezuela, defaults on business and consumer loans are rising very rapidly and the austerity measures being implemented by the Zedillo government at the behest of foreign creditors will only exacerbate credit quality concerns. As I will address in greater detail below, this dismal economic situation has profound implications. Most importantly for our purposes today, on an aggregate basis, the Mexican banking system is clearly insolvent and cannot survive in its present form. It is very likely that many if not most of the recently privatized Mexican commercial banks will require government assistance and/or outright takeover before year-end 1995.

2. The speculative economy, fueled by inflows of cheap dollars, inflated to vast size between 1990 and 1994. Now this process is moving in reverse as the collapsing prices for stocks, bonds and the peso destroy billions of dollars in wealth and reduce consumer purchasing power. Over the past year, Mexico's overheated stock market lost over 30 percent of its capitalization, falling to roughly $90 billion from $129 billion at year-end 1994. By shifting the dollar borrowing necessary to finance imports -- and

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[6] See "Crece el Numeros de Empresas que no Pueden Pagar Impuestos," *Accion*, May 15, 1995, pp. 10-12.

thus political stability -- from the public to private sector since 1989, Salinas and his cronies in the previous government cleverly made Mexico's economy seem larger through new *dollar* inflows, while leaving the ultimate liability with the private sector -- and the Mexican people.

The economic policies of Carlos Salinas emphasized the sale of state run companies and the raising billions of dollars in new foreign debt rather than boosting exports and job growth. The result is an economy that has more debt and arguably less ability to generate *dollar* income than it did in 1989. Moreover, as the productive economy has suffered, more and more people in Mexico are reluctantly turning to immigration, financial speculation or illegal activities in order to earn a living.

When stock market analysts and/or members of the Clinton Administration says that the Mexican economy is "recovering," what they mean is that the speculative sector is stable. Unfortunately, this has little immediate or even long-term benefit for or impact on the productive sector where the majority of people live and the income to service Mexico's foreign debt must be generated. <u>Once again, as in 1982, Mexico is in trouble because of excessive offshore borrowing and spendthrift economic policies, not because of a short-term liquidity problem, as the Clinton Administration suggests</u>. As I have already noted, the huge payments that Mexico must make to foreign creditors are already strangling Mexico's productive economy, as illustrated by very high real interest rates, and are making it impossible for private individuals and companies to survive much less grow.

3. Finally we come to the criminal economy, by far the largest of the three sectors of the Mexican economy, which is built around narcotics trafficking, arms smuggling, kidnapping and other forms of illegal activity. The criminal economy has mushroomed in size over the past decade and now clearly dominates the entire political economy of Mexico. By way of comparison, consider that the $25-30 billion in profits from the $100 billion-per-year narcotics trade is twice the total *revenues* of Mexican oil sector.

Drugs are not simply a threat to the authority of the Mexican government, as even U.S. officials now grudgingly admit. Rather, as in the case of Colombia and Venezuela, narcotics has come to permeate all aspects of Mexican official and even private life. It is frequently impossible to do business or even live in many parts of the country without making a *compromiso* with the warlords who govern the narco system.[7] Drug lords and their allies in the Mexican government apparatus are now the ascendant political force in border states like Baja Norte, Sonora, Sinaloa, and Cuahuila, and in many other parts of the country.

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[7] See Whalen, Christopher, "Mexico: El Sistema Narco," *Dinero* of Bogota, Colombia, November 1994, pp. 162-176.

Narcobusiness

"Privatizations"

As the **Bogota** cartoon from *El Financiero* suggests, many Mexicans believe that a direct connection exists between the speculative sector of the economy and drugs. There are persistent indications and reports that (1) much of the money obtained since 1989 to finance the purchases of state-run enterprises in Mexico, including the commercial banks, came from narcotics activities and (2) that the enormous flow of drug money in Mexico is corrupting financial institutions of all kinds. There are also growing numbers of examples of how this money is moving across the border to purchase American banks and companies. For example:

◆ In a report prepared by the FBI, **James Moody**, head of that agency's narcotics section, says that "companies in the process of privatization in Mexico under President Salinas were purchased by narcotics trafficking organizations in Mexico and Colombia."[8] Apparently the report was used as the basis of a closed-door meeting held between the FBI, State Department and CIA in November of 1994 here in Washington.

[8] See Estevez, Dolia, "Corrupcion y Narcolavado en las Privatizaciones Salinistas: FBI; Magnates Mexicanos, Involcrados," *El Financiero*, May 9, 1995, pp 1&30

◆ The collapse in early September 1994 of the **Cremi Union** financial group illustrates another situation involving fraud and suspect sources of financing. **Carlos Cabal Peniche** was a business man of little apparent wealth or influence until the beginning of the six-year term or *sexenio* of Carlos Salinas. He had previously had business ties with shady Middle Eastern business interests connected with the renegade offshore bank, **BCCI**. In a matter of months, Cabal amassed sufficient financing to acquire several banks as well as a large part of the operations of the U.S. agribusiness **Del Monte** in Mexico and Central America. Fraudulent business practices and insider loans eventually caused his bank to fail, but the episode still leaves unexplained how this obscure individual came to be a leading business figure with a reported net worth over $1 billion. Today, Cabal is a fugitive and his financial Ponzi scheme lies in ruins with hundreds of millions of dollars in losses for the government and investors.

In purely financial terms, the Mexican meltdown signals the end of the latest cycle of offshore investment in Latin America, a reversal of the rising dollar monetary tides engineered by the Federal Reserve Board between 1989 and 1994. But the peso devaluation and financial collapse of the past two months has as much to do with changes in U.S. interest rate policy as with the peculiar relationship between Washington and the nations south of El Paso. The real blame for the Tequila Effect and the extraordinary accumulation of new debt by Mexico largely belongs with Washington. Had we dealt directly and forthrightly with Mexico's debt problems in 1982, we would have a different and probably much smaller financial crisis today.

The Banks

It is impossible to have sound, solvent banks in an economic environment that is as hostile and difficult as the one that I have just described. Commercial banks are a reflection of their customers and markets, thus given the rapid deterioration of the productive sector of the Mexican economy, it is logical to infer that the banking system is also in

serious trouble. The efforts by the Mexican government to staunch the rising tide of inflation in the country are having an extremely adverse impact on the overall liquidity of the country's businesses and financial institutions. For example:

◆ Many of Mexico's banks are and will probably remain deeply insolvent, no matter what local regulators, bankers and politicians say to the contrary. Most Mexican banks are bankrupt because large proportions of their customers have lost businesses and/or jobs, and are in default on a variety of financial obligations. The National Coordinator for Bank Customers (CNUB) estimates that 70 percent of consumers have serious financial difficulties. Another estimate claims that as many as 4 million credit cards are in default in Mexico, more than half of the total outstanding. Real interest rates and charges for bank services are astronomical. Today, a peso-denominated commercial loan for a solvent business with good credit would cost well-over 100 percent annually.

◆ Bad loans held by the Mexican banking system went from 7.2 percent of total loans at year-end 1994 to 12.1 percent at the end of March, according to the Mexican Banking Commission. A Mexico City financial analyst notes that commercial banks are "killing their customers" in order to remain liquid and that loan losses are many times the loss rates in official figures. At the end of April, the margin of intermediation or the difference between a bank's cost of funds and the rate charged good customers for loans was 32 percent annually, roughly 6 times the margin charged by U.S. banks.

◆ Mexican banks are moving bad mortgage and consumer loans off their books and into off-balance sheet trusts in order to shore up badly depleted capital levels. This accounting maneuver may make the banks appear more solvent, but the reality of scarce *liquidity* is confirmed by the fact that the **Banco de Mexico** (*Banxico*) has been making massive cash infusions into individual banks through advances to the bank deposit insurance fund. As Venezuela has done over the past 18 months, the Mexican government is slowly nationalizing private banks and brokers. The actual level of credit losses in these banks is many time higher than these figures would suggest because of large-scale forbearance by bankers unable or unwilling to declare non-performing loans in default. Banks simply "roll" bad credits by lending enough new money to cover accrued interest, thus temporarily maintaining the fiction of repayment.

◆ In real terms, the outstanding balances on peso credit cards fell 7.4 percent in 1994 compared to a real, inflation-adjusted increase of 8.5 percent during 1993. As of September 1994, the outstanding balances of peso credit cards issued by Mexican banks equaled N$25.6 billion. Nearly half of this amount represents accrued interest on outstanding balances. During

the Salinas *sexenio*, Mexican banks were extremely liberal, almost reckless, in their policies regarding approval of new credit card users. Until the middle of last year, roughly one-third of the urban population of Mexico qualified for credit cards, even though in many cases these new cardholders did not have sufficient income and net worth to support any level of consumer debt. Interest rates charged by the banks were also a problem, with annual rates ranging from 40 percent for cards issued by **Banamex** to 69 percent for **Banca Serfin** at the end of last year. One reason for the sudden change in bank policies regarding credit card issuance has been the sharp rise in defaults. In 1991, the average rate of loss on peso credit card portfolios was 9.4 percent, acccrding to the *Comision Nacional Bancaria*. As of September 1994, the official default rate had risen to 22 percent of total card balances and this rate has soared since the December peso crisis began. Whereas in January Banca Serfin charged 63.60 percent on outstanding credit card balances, in the first week in May the bank charged almost 100 percent annual rates of interest on its credit cards.

◆ In April, Mexican businesses and individuals showed by far the worst indications in almost four years with respect to liquidity and overall solvency. According to a study by a Mexico City credit firm, in the first quarter of 1995 the number of business and individual debts in arrears rose 400 percent compared to the same period a year before.

◆ Nearly 95 percent of the members of *El Barzon*, the nation-wide group that represents troubled debtors in Mexico, so far are not included in government sponsored debt relief schemes. Millions of middle and lower-middle class Mexicans are losing jobs, homes and lives for the first time. The vicious process of foreclosure and defaul now underway in Mexico is comparable to the U.S. experience in the 1930s and far exceeds the level of dislocation experienced in the 1982 debt crisis. If one accepts the classical notion that the particular leads to the general, a close examination of the credit environment in Mexico at the micro level suggests that the country is headed for a *de facto* macro debt default later this year.

Conclusions & Recommendations

◆ If Wall Street's renewed appetite for paper issued by Mexican banks depends upon high margins charged for loans and other services, then they had better think again.[9] There cannot be sound banks in a bad economic environment. When bank customers cannot pay usurious rates to borrow money or for other bank services, the question is begged with respect to overall solvency within the market. As in the case of Venezuela, where most banks, exchange houses and insurance firms are now in government hands, Mexico too must recapitalize its financial system. <u>There may or may not be any additional outright "failures" of Mexican banks, but a bailout is underway with negative consequences for the fiscal balance and for inflation</u>.

◆ Falling government revenues and the cost of maintaining liquidity in the banking system mean that Mexico must and will run the monetary printing press. The only rational way to lessen and perhaps even escape from the inevitable hyper-inflation that must follow from the government's current policies would be to declare a bank holiday, close and re-open Mexico's commercial banks based upon a strict test of solvency, and then embrace monetary stability via a currency board or other similar mechanism. <u>Without tough new measures to control inflation and restore stability to Mexico productive sector, the country faces hyper-inflation and debt default</u>.

◆ The Clinton Administration's assertion that the Mexico bailout is somehow a benefit for the millions of people in difficulty south of the border is a gross distortion of the facts. [10] The moneys being disbursed by the U.S. government are simply being transmitted through the Mexican central bank to private investors, either foreign or domestic. The best that can be said about the Mexico bailout is that it subsidizes the losses of private U.S. investors who were foolish enough to gamble their money away in Mexico. At worst, this taxpayer financed bailout is a giveaway to the owners of Mexico's business and political elite, many of whom have direct and indirect ties to narcotics trafficking, money laundering and other illicit activities. <u>It is important to note that many of the deposits and private debt obligations refunded by the Clinton bailout for Mexico have involved banks and commercial entities that have neither been closed nor declared insolvent</u>.

[9] Banamex recently issued $206 million in certificates backed by future wire transfer receipts. The May 17, 1995 deal was placed by **Merrill Lynch** and **J.P. Morgan**.

[10] For an excellent critical discussion of the Administration's position in support of the bailout, see the May 12, 1995 letter from Walker F. Todd to Rep. Marcy Kaptur. See also the affidavit by Dr. Anna J. Schwartz filed in <u>Robert L. Schulz et al. vs. the State of New York</u>, No. 95-CV-0133 CGC DNH. To paraphrase Dr. Schwartz, government intervention in financial markets is "an exercise in futility."

◆ To a large degree the financial bubble in Mexico that expanded between 1989 and 1994 was a political event. The rush of investment across the border was fostered not only by low interest rates in the U.S. but also through a deliberate, concerted effort of the Washington foreign policy and national security apparatus to maintain single party rule in Mexico. A pointless and self-destructive legacy of the Cold War, U.S. support for single-party rule in Mexico has meant American acquiescence and complicity in official corruption on a truly unprecedented scale, even by modern Mexican standards. The real blame for the Tequila Effect and the preceding accumulation of new foreign debt that will drive the painful next round of debt restructuring largely belongs in Washington. Of course, it was the coincident easy money policy of Federal Reserve Chairman **Alan Greenspan** from 1989 through February 1994 that made the bubbles in Mexico, Argentina and other "emerging markets" so large and the potential losses so horrific -- totaling in the many tens of billions of dollars.

◆ Early in 1995, the size of the collapsing emerging market bubble so terrified official Washington that Treasury Secretary **Robert Rubin**, the only senior Treasury official with any real financial experience, discarded his first and best impulse to let the markets clean up the mess and embraced a public bailout for private investors in Mexico. It is some measure of the ethical laxity of Washington that this rescue for friends and former clients of a sitting Treasury Secretary went almost completely unchallenged. Rubin, lest we all forget, is the chief fiscal officer of the United States. <u>When a Treasury Secretary condones a public bailout for private foreign debts, he commits an act of fraud</u>. Why quibble about such old-fashioned notions as fiduciary responsibility? Because the investment bankers who created the illusion of solidity in authoritarian nations of Asia and Latin America also typify the modern-day corporativism that passes for pluralistic politics in Washington, a cynical cronyism that privatizes profits and socialize losses, that encourages favoritism and eschews free competition, and all the while helps emerging nations and, yes, even Uncle Sam, issue endless piles of debt that will never be repaid in kind.

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THE MEXICAN PESO CRISIS

FRIDAY, JULY 14, 1995

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:05 a.m., in room SD–106 of the Dirksen Senate Office Building, Senator Alfonse M. D'Amato (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN ALFONSE M. D'AMATO

The CHAIRMAN. The hearing will come to order. Today, the Committee continues its hearing as it relates to the utilization of the monies from the Exchange Stabilization Fund that the Administration has used in its plan to help to aid the Mexican economy.

We continue to monitor the crisis and the Administration's use of taxpayers' money to bail out the Mexican government and global speculators.

On July 5, 1995, the Administration sent another $2.5 billion to Mexico. This was the first business day that the second $10 billion became available under the terms of the agreement with Mexico.

Senator Dole and I sent a letter to Secretary Rubin expressing our concern about the release of these additional funds so early in the process. The Administration's previous representations are difficult to square as it relates to the distribution of another $2.5 billion.

The fact is we had heard that these dollars would not be drawn down. As a matter of fact, we were told that these monies, the second $10 billion, were there for emergency purposes.

We hear good news as it relates to the Mexican economy in the sale of their last bond issue. It raises the question that, if this is taking place, and we are delighted that they had this oversubscription, what emergency came about in the past 10 days that justified the use of this, and I quote, "contingency fund"?

The Committee certainly has not been informed of any emergency that would warrant the release of these additional taxpayer dollars. We know that roughly $6 billion in Tesobonos are maturing in July and August. The question is: Is the Administration going to continue to draw down the dollars to meet these obligations?

The thing that this Senator finds disturbing is that the use of these dollars is being made in a manner in which private investors are recapturing their investment, plus all of the interest, in some cases 20 to 25 percent, that their initial investment called for.

We don't do that for U.S. taxpayers. Yet, we seem committed to a course of action that does this.

Now, yesterday, I had an opportunity to speak to Secretary Rubin, and he sent a letter that I believe contradicts previous representations made by the Administration. The letter states that the Treasury Department's past position has been that the second $10 billion would be used if the stabilization program was working.

This is at variance with what we've been told.

On February 21, 1995, the Treasury Department briefed the Committee staff and provided a document that states, and I quote:

> The remaining $10 billion will be undrawn, but will be available for contingencies.

That's where we have a very real difference. You can't, on the one hand, say you're not going to use the $10 billion, that it's going to be there for contingencies, and then, on the other hand, on the first date available begin a drawdown.

That seems to me to be a contradiction, and I certainly raise the question, how is it?

The Mexican government's financial plan, which was required by the agreement and approved by the Administration, also states unequivocally that the second $10 billion of the U.S. Government fund is not intended to be used in 1995, but will be available for, and I quote, "but will be available for unforeseen contingencies."

Now, this is a plan that was developed not just by Mexico in a void, but was approved by the Administration and was part of our agreement with them.

That's why I ask what were these unforeseen contingencies? When did you find out about them? Were they unforeseen then? What has changed? What has changed that would require you to draw down?

That's why I say there's a very real question here.

Again, on March 7, 1995, Under Secretary Summers testified before the House Subcommittee on International Economic Policy, and I quote:

> This plan calls for using about half the resources we are making available, holding the other half for contingencies.

Again, it seems quite clear what we were told is that this $10 billion wasn't going to be used.

The Secretary's letter to me states that:

> The Treasury Department regrets any incorrect impression that the second $10 billion would only be used in an emergency.

This certainly was not the impression that we were given. There are definite, precise statements and times given to Congress, given to the staffs of Congress, and to the American people. These are promises included, again, as I mentioned, in the Mexican government's financial plan and approved by the Administration.

It boils down to a matter of having the right to know what we're doing, how we're doing it, and is it true? Are these monies going to be set aside? Two and one-half billion dollars already has been drawn down. Is the rest of the money going to be drawn down?

I'm very concerned and I would like to be quite candid and say that it seems to me it's about time the rest of the monies, that the International Monetary Fund and others have promised, be drawn down first, and that the dollars the United States has indicated would be available would be used only if there's an emergency and only in a contingency.

So that's the nature of this hearing. That's the direction I am heading in terms of attempting to find out, are we really going to draw down the rest of this? Were we told one thing and are we doing another? If there was a misimpression, it seems to me it would reinforce those statements on, again, three separate occasions. That's why it leaves me wondering what the real situation is.

Senator Boxer, do you have a statement?

OPENING STATEMENT OF SENATOR BARBARA BOXER

Senator BOXER. Yes, I do. Thank you, Mr. Chairman.

Mr. Chairman, this marks the fifth occasion on which the Committee on Banking has met to discuss the Mexican economic crisis. While I do not wish to rehash what has gone on before, I would like to follow up on some of the issues which were raised by the Administration's decision to use U.S. funds, through the Exchange Stabilization Fund, in order to bail out the Mexican government and wealthy investors, the Tesobono holders.

Specifically, I have questions about the United States always being looked to as the principal lender of last resort for Mexico and other countries which may have severe economic crises in the future.

Given our current budget restraints and our pressing domestic needs, I don't think we should set a precedent which suggests to the governments of other emerging countries that the United States will come to their economic rescue if they're unable to pay off their bondholders.

I would like to know what measures can be implemented in order to prevent the United States, and the American taxpayers, from being that proverbial lender of last resort to other emerging markets.

I know that the G–7, during its meeting in Halifax, discussed ways in which to help avert another economic crisis like that which occurred in Mexico, as well as ways to provide financial assistance to severely economically distressed countries. I am interested in hearing what ideas were proposed in this regard and which are deemed to be the most feasible.

Beyond those issues, however, I am concerned with the apparent inconsistency between public statements made touting the stability of the Mexican economy and the stark reality.

The stark reality is that unsound macroeconomic practices by the Mexican government caused a severe liquidity crisis, as well as an overvaluation of the Mexican peso.

Such statements gave the United States, as well as other investors, a false sense of security regarding Mexican investments.

While I understand that there were political and diplomatic interests which had to be considered, I do think the proper course of action would have been to remain silent, rather than to offer public proclamations attesting to the firmness of the Mexican economy and hailing it as a prototype for other emerging markets in Latin America.

These investors depend not only on their own market analyses, but also on the statements of Government officials charged with disseminating accurate financial information and forecasts.

While there are many lessons to be learned from the near-crippling economic crisis which occurred in Mexico, one of the most important, I believe, concerns our participating in or encouraging emerging countries to cover up, hide, or shade financial indicators considered unfavorable to their markets. Bleak financial data cannot be covered up, hoping that the underlying dismal economic situation will somehow improve and no one will be the wiser. Mexico proves that, sooner or later, and often sooner, the actual situation is exposed, and investors are sent scrambling.

Finally, our taxpayers cannot afford to ever again make whole, and Mr. Chairman—Mr. Chairman, I want to address this to you because I know you care about this issue.

Our taxpayers cannot afford to ever again make whole bondholders who make highly risky investments in emerging markets, knowing that these investments tend to be thinly capitalized and illiquid.

These investors, aware of all the risks, chose to invest in Mexico in hopes of reaping large profits through the high interest rates being paid. In so doing, they also assumed the risk of having to bear losses, no matter the magnitude of those losses. I know that Secretary Rubin was concerned about this issue.

The theory of caveat emptor applies to Tesobono investors as well. I feel very strongly about this, Mr. Chairman, perhaps because of my recent experience in California, where truly innocent investors who made safe investments in Orange County are not going to be made whole.

So why do we make these people whole?

It's so unfair, it sticks in my craw. I hope we can perhaps look at ways to prevent this from ever happening again.

Mr. Chairman, I feel very strongly about this issue. I'm glad we're looking at it. I think we have people who are trying to resolve this crisis. I think there's some good news coming out of what has happened, but it does not erase some of the issues that we have raised here today.

I, unfortunately, have to go to the Chinese embassy early this morning because of the Harry Wu matter. I would ask if you would introduce some questions I have for Secretary Rubin at the end of the hearing?

I thank you very much, and I thank you, Secretary Rubin and Mr. Summers.

The CHAIRMAN. I certainly will raise those questions.

Senator BOXER. Thank you.

The CHAIRMAN. I want to say that the Senator, encapsulating her concern, is wondering how it is that, essentially, $12½ billion—and I believe we'll try to elicit how much of those monies went to the holders of the Tesobonos and to bondholders—basically bailed out people who made investments, many with institutional representation, sophisticated investors who saw an opportunity to get high yields, high returns. She's wondering how it is that the American people now are having to pay off their investment, that otherwise would have gone sour, and pay them off dollar for dollar——

Senator BOXER. Right.

The CHAIRMAN. —plus all of the interest. You raise the question of Orange County. We wouldn't do, have not done, or even ar-

ranged to do, a rescheduling or guarantees of the Federal Government to help Orange County in this matter. Yet, here it is. We don't even know the people, how many of them were U.S. citizens, how many of them were foreign nationals, or how many of them were large institutions, but we helped them to repay these dollars.

Notwithstanding that Mexico has been able to go to the market with a bond issue, which is very interesting, I think the real crisis is one of political stability and maturity in that area. This package of rescuing private investors I don't believe even begins to address that.

I don't understand how, on one hand, we can talk about developing free markets and, on the other hand, do exactly what you don't do with free markets—have the Government come in and bail them out.

Now, if that's the way we're going to get capital into Mexico, to guarantee to anybody who defaults that the U.S. taxpayer will be there, I think it's an abdication of our responsibility.

Here we are—and it's ironic, and I'm going to turn to Senator Bond, who has been very patient—it's ironic that we are passing on a budget that will cut—and I don't care, at this time it may be basically the Republicans in Congress, but at some point in time, even the President has put forth a budget that, over 10 years, will cut hundreds of billions of dollars. This means that we're going to be cutting back or reducing the rate of growth of very important programs; cutting back funding for education, highways, mass transportation, housing, and home heating oil programs.

Lots of those programs are rather important to the people.

We're struggling to find nickels and dimes, struggling for money in research, and we, just in this manner, dispose of $12½ billion.

I'd like to stop the other $7½ billion from being withdrawn, unless you can show us how it's going to benefit the American economy, because I don't believe that the Mexican government is ever going to be able to repay us. I know some people say they will, I doubt it. They haven't paid, since 1982, on the deals they made with the banks. We seem to forget that.

But you raise a very real question—should we be in the business of picking up private investors' losses around the world in emerging markets?

I don't think we should.

Senator Bond.

OPENING STATEMENT OF SENATOR CHRISTOPHER S. BOND

Senator BOND. Thank you very much, Mr. Chairman. I commend you for holding the hearing today.

I want to say to my Ranking Member on the International Finance Subcommittee that the exact points, the questions you raised are questions that I have as well.

Mr. Chairman, your effort to further public understanding of the use of the Exchange Stabilization Fund to support the Mexican peso I think is an important public service and I'm delighted to be able to join you briefly.

Unfortunately, I have some commitments to work on those cuts that you were talking about in housing, veterans, space, and other issues, and I'm going to have to leave. But I have had the oppor-

tunity to read the advance statements of our very distinguished witnesses today and I will be following the question-and-answer session carefully.

In the past, I made it clear I'm concerned about the use of the ESF to support the peso. The ESF was established for the purpose of stabilizing the U.S. dollar, not the Mexican peso or any other foreign currency.

I'm concerned about the precedent we're setting and worried about the potential impact on our ability to intervene in currency markets in support of the dollar, if and when that may become necessary. I think we need to be paying attention to that.

As you noted, we have already committed $10 billion in support of the peso. I'd agree that we have a strong interest in stabilizing the Mexican economy. There's no way that we're going to be separated from the Mexican economy. It is in our interest that the economy of Mexico be stable, but I question whether we have had a sufficient impact on the economy itself to justify these huge sums.

Several economists have told this panel already—no bailout, regardless of its size, will solve Mexico's problems without fundamental economic reforms.

I would offer for your consideration, if you've not seen it, a comment by Steve Forbes, who, in fact, commented in Forbes, July 3, 1995, in part, as he talks about the Administration's efforts to assist the peso and the fact that Mexico went from having a substantial trade deficit to a surplus.

Steve said:

> Sadly, they are wrong. The Mexican economy continues to unravel. Countless small businesses are shuttering their windows. Unemployment is rising. More disheartening, the government still won't stabilize the peso against the dollar at a fixed rate or within a narrow band, almost guaranteeing more deterioration, which in turn will keep real interest rates high and retard future recovery.

I certainly think there are positive steps that have been taken. There has been some favorable economic news out of Mexico. That is good for all of us.

The fact remains, however, the Mexican economy is in serious trouble. Banks are in jeopardy of default, small businesses are struggling, and, of course, the high unemployment rate is a continuing concern.

It was my understanding, from previous conversions with Administration officials, that the release of the second $10 billion was not anticipated, that it would only be available for emergencies.

Thus, the questions that come to my mind—does the Administration believe the Mexican economic situation has begun to stabilize, or does it remain in an emergency?

If it remains in an emergency, how have we been successful? If it's stabilized, why do we need more money?

Somehow, I can't quite reconcile those.

What's our likelihood, as the Chairman pointed out, of ever seeing these funds again? Finally, as I've already asked, how does the use of $20 billion impact our ability to intervene on behalf of the dollar, which is the purpose of the Exchange Stabilization Fund in the first place?

I know, from the written testimony, you believe that Mexico is moving in the right direction and that these additional funds will

help. I continue to question that conclusion, however, especially given the clear indication I derive from both of your statements that our funds are going directly to pay off holders of Tesobonos.

As both of my colleagues have pointed out, we're holding harmless people who decided to take a crap shoot and put money into very high-risk and, thus, high interest rate-bearing securities or bonds. They took the risk and we not only paid off, paid them back their money, but we paid them back those interest rates.

I'm hopeful that the hearing will shed some light on these questions.

I sympathize with the difficult situation you're in. I know the commitment you have, and legitimately so, for seeing that the economy of a very, very significant neighbor does not collapse.

I don't have a clear-cut answer. If I did, I would have said so long ago. But I am troubled by the path we seem to be going down right now.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Bond.

Senator Faircloth.

OPENING STATEMENT OF SENATOR LAUCH FAIRCLOTH

Senator FAIRCLOTH. Thank you, Mr. Chairman. I'm sure there are a lot of people in and out of the Administration that wish this whole thing would go away. But when $20 billion of the taxpayers' money is at stake, it isn't going away.

We had testimony about a month ago from a panel of Mexican citizens, very prominent ones, and those involved in the government. Each of them agreed that the United States would never be paid back.

Further, they said, and I think correctly, that the money was not being invested in Mexico, that the Mexican government was just a weigh station and the money was simply being floated outside of Mexico to pay off debtors and holders of the Tesobonos.

I want to ask Secretary Rubin if he thinks $20 billion of the U.S. taxpayers' money should be used to pay off the investors in these bonds, who are getting from 20, 30, to 40 percent interest on the bonds?

I don't think so.

I'm convinced Mexico will use every dime of the $20 billion. There's no question about that. Again, when the Mexican citizens testified, they said Mexico would get the next $10 billion if there was an emergency. Of course, the emergency occurred at 12:01 a.m., July 1, 1995. Certainly, there will be more emergencies until the $20 billion is gone.

My question is, when we get to the questions, when the $20 billion is gone and the emergencies still keep occurring, what do we do then?

If $20 billion is some magic figure that is going to put Mexico on the road to fiscal responsibility and recovery, then it will be the first time in Mexico's history that any amount of money did it.

Mr. Chairman, I thank you.

The CHAIRMAN. Thank you, Senator Faircloth.

Secretary Rubin, thank you for coming today. Mr. Summers, thank you.

OPENING STATEMENT OF ROBERT E. RUBIN, SECRETARY, U.S. DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Secretary RUBIN. Thank you, Mr. Chairman. You and the other Members of your panel have raised a large number of, I think, very important questions. Hopefully, my opening statement, and Under Secretary Summers' opening statement, will be responsive to most of them. In addition, we obviously would be delighted to continue to respond during the questioning period.

Let me just respond to one thing at the very beginning, if I may, before I get into my testimony, this question of using the money to pay off Tesobono holders.

We have testified previously that we would not have spent one nickel, not one nickel, for the purpose of paying off Tesobono holders. The objective here was to create stability and then prosperity in Mexico.

As Chairman Greenspan said when he testified with us one earlier occasion, when you engage in an effort of the type that we are engaging in here, there are sometimes incidental beneficiaries, as, for example, happened when the Federal Reserve Board intervened in 1987, to prevent a collapse of the American financial system after October 19, 1987, and the collapse of the stock market.

There were many, many beneficiaries in the bond markets from what the Federal Reserve Board did during and after October 19, 1987. But, had the Fed not acted, there was a real risk that we would have had a collapse of our financial system.

Similarly, here, the entire objective, the only objective, the sole objective, was to put Mexico back on the road to stability and prosperity. We would not have spent one nickel for the benefit of Tesobono holders.

However, there was no way to do that without providing the funds that then went, in some fair measure, to pay off Tesobonos and eliminate that enormous burden on the Mexican financial system.

With that, let me go to my testimony and, then, we would be glad to respond to anything that you would like to discuss.

As a number of you have said, since we've last testified, certainly since I've last testified, there's been substantial progress in Mexico. The stabilization program has gained very significant ground. Mexico continues to face substantial challenges, but we are very encouraged by progress achieved to date and have every expectation that we will get repaid in full. The objective of promoting United States exports, jobs, and the security of our borders, in our judgment, is being accomplished. We have also avoided the spill-over into other emerging markets that we think could easily have happened, Chairman Greenspan and I both testified, could easily have happened had Mexico gone into default.

The United States-led international support program has been essential to Mexico's success so far. Our funds, along with financial support from the international community via the IMF, the Inter-American Development Bank, and the World Bank, have supported Mexico in implementing the policies needed to put its economy back on the path toward prosperity.

As you know, on July 5, 1995, the Treasury provided $2.5 billion in additional support to Mexico, bringing the total to $12.5 billion.

You have raised the question, rightly, why, if Mexico is making substantial progress, do we provide this latest disbursement?

This is an important question that Under Secretary Summers and I will both address in our testimony today.

On January 31, 1995, with bipartisan support of the congressional leadership and the support of the Chairman of the Federal Reserve Board, the President acted to safeguard important American interests by authorizing up to $20 billion in support to Mexico through the ESF. Potential escalation of the crisis in Mexico was a direct, long-term threat to American economic and national security interests.

Moreover, as I mentioned a moment ago, Mexico's difficulties threatened to spill beyond its borders to affect other emerging, developing, and transitional countries. Our leadership was central to protecting our interests and to marshaling international support.

On February 21, 1995, I signed four agreements to implement the plan. These agreements were based on one, and only one, overriding principle and consideration: The need to protect United States interests. They contain rigorous economic, financial, and reporting requirements to ensure that all U.S. resources committed in this program are secure. Funding to Mexico has been provided in stages and, before each disbursement, we have verified that Mexico continues to meet these strict conditions.

The agreements provide assured backing for our support from Mexico's oil export proceeds. Given the importance of that program, we formed an interagency working group to analyze Mexico's oil export prospects over the long term. Those have been reevaluated since the signing of the agreements. The group's conclusions confirm that Mexico's oil export revenues will fully back all outstanding disbursements and potential disbursements under this program.

Mr. Chairman, when I first appeared before this Committee some 4 months ago, it was far too soon to make anything but the most preliminary judgment about the probability of success, though it was certainly our view that the plan should work. Today, the signs of success are substantial. Moreover, Mexico's government has demonstrated a steadfast determination to meet its commitments, and take the steps necessary to restore financial stability. Market confidence has begun to return, and capital inflows to Mexico have resumed. Mexico's money supply, on an inflation-adjusted basis, has declined by 38 percent this year. Mexico has moved to a fiscal surplus, and to a trade surplus. The outstanding stock of Tesobonos, which were at the heart of the Mexican crisis, have been reduced from $29.2 billion at the time the crisis hit to $8.9 billion today. More than $2 billion in dollar borrowings from the bank insurance fund have been repaid.

The crisis of confidence which Mexico's situation created in other emerging markets has subsided. Mexico is regaining access to international capital markets faster than we had expected. Just this week, as the Chairman indicated, the government returned to the international markets with a highly successful bond issue. The success of that issue indicates the confidence the banking system has that Mexico has become a credit-worthy borrower.

While our assistance program is not conditioned on political and judicial reforms, its support of economic stabilization has increased the prospects for success in these areas as well. Since taking office, President Zedillo has moved to weed out corruption and has taken steps to continue reform of Mexico's judicial and electoral systems.

Mexico is making progress on other fronts. United States–Mexican cooperation in combating illicit drug trafficking has improved markedly. Attorney General Reno has held repeated talks with Mexican Attorney General Lozano beginning on the day that President Zedillo was inaugurated. The two have established a new, intensive coordination mechanism at the senior policy level. The Justice Department informs me that Mexico's resolve has begun to bear fruit, such as the arrest 3 weeks ago of Hector Salazar, a powerful Mexican drug leader, the capture of Jose Sosa-Mayorga, an important criminal kingpin, in late May, and the April seizure of a record $6.35 million in cash at Mexico City's airport.

The international financial community has also learned much from Mexico's experience. The Halifax initiatives reflect the lessons of the Mexican experience and, if put in place, give us confidence that the United States will not have to function as a lender of last resort in future situations.

Clearly, Mexico has come a long way in a short time. With a strong trade performance, sound financial policies, and continued structural reform, in our judgment, economic growth should return by 1996. Our decision to disburse $2.5 billion last week, at the same time that the IMF made a disbursement of $2 billion, supports continued Mexican progress and U.S. interest in solidifying the prospects for Mexico's success.

In the press release for the Mexican support program, issued when we signed our agreements with Mexico, I stated that, and I'd like to quote, Mr. Chairman, "Ten billion dollars will be made available in stages between now and the end of June 1995, and using the same terms and conditions, another $10 billion will become available, as needed and in stages, beginning in July."

I have with me, Mr. Chairman, a goodly number of statements, as time went on, that were issued by the Treasury Department pretty much to the same effect, albeit, sometimes in slightly different language.

As noted in the letter which you and Senator Dole recently wrote to me, Mr. Chairman, Mexico indicated on February 21, 1995, that the second $10 billion would be available for unforeseen contingencies. It was our hope, clearly shared by Congress, that it would not be necessary to utilize the second $10 billion of the $20 billion support package. However, it was always our intent that the money would be available, if needed, if Mexico was meeting its commitments, and that is exceedingly important, and if the program was on the road to success, in our judgment.

To the extent that we, by referring to contingencies, created any incorrect impression, we certainly regret having done so. But, once again, Mr. Chairman, I think the intent that we had and the criteria that we were applying were clear in a series of statements we made from the time we first signed the agreement down to the present date.

Our decision to disburse $2.5 billion last week reflects our belief that the program is working, that the funds are needed, and that the Mexican commitments are being satisfied. Data on capital flows continuously becomes available that informs our assessment of Mexico's financing needs. In view of the heavy amortization schedule this summer, our desire to promote the rising tide of market sentiment and confidence in Mexico, and our current forecasts for net inflows of funds from all sources in the third quarter, we decided that it would be prudent and wise to disburse these funds.

Mr. Chairman, I think one of the best ways to understand why the United States-led effort is so important is to put Mexico's present difficulties in a stark perspective. The current crisis has been compared to Mexico's debt crisis of 13 years ago. That crisis spawned economic calamity, first in Mexico, then, a few months later in Brazil, and, finally, throughout Latin America. It led to what has been called a lost decade of protectionist policies, negative growth, financial instability, and political and social unrest in much of this hemisphere.

Here at home, Mexico's and Latin America's difficulties in 1982 posed a serious challenge to the health of our financial system. They sent the number of illegal immigrants who were crossing into the United States sharply higher. Ultimately, Mexico and Latin America's collapse deprived our economy of a full decade's worth of opportunities for trade and investment.

Mexico's economy is not what it was in 1982. After 7 years of reform, the pieces are in place for Mexico to avoid a repetition of the lost decade and, instead, to achieve a healthy rate of economic growth. It was to avert another lost decade and all the harm it caused us that the United States chose to lead the present support effort for Mexico. We are now on the path toward success.

The 1982 crisis prompted a severe wage-price spiral. Prices soared by 42 percent in the first 6 months, and the inflation rate eventually hit 110 percent. Today, the situation is exactly the opposite. Though prices rose very sharply in the first 6 months, inflation is now falling.

In 1982, Mexico's currency continued to depreciate sharply, by a full 73 percent between January 1982 and January 1983. This time, the decline halted after an initial 55 percent fall and has since strengthened by 23 percent, while, at the same time, and this is extremely important, Mexican reserves are rising.

Mexico's current account deficit has moved in a very favorable direction and so has what has now become a fiscal surplus.

Most importantly, perhaps, in 1982, Mexico and other Latin American countries initially responded to difficulties by retreating from the kind of free market measures we have sought to promote for decades. The Mexican government imposed exchange controls, raised import restrictions, nationalized the banking system, suspended debt repayments, and generally retreated behind protectionist walls.

The outlook is very different in 1995. This time Mexico's difficulties have prompted the government to accelerate privatization, and to free up wage bargaining and other sectors of the economy more quickly. The Mexicans are moving swiftly to shore up their financial, regulatory, and legal environments, while lifting restrictions

on foreign investment. Also, very importantly from an American perspective, the Mexicans have chosen to keep their markets open. This embrace of the market should enable Mexico and the United States to escape another lost decade.

Mr. Chairman, Under Secretary Summers will now describe in greater detail the changes we have seen in Mexico's economy over the last 6 months. Both of us would be delighted to respond to any questions you might have.

The CHAIRMAN. Thank you very much, Mr. Secretary.

Before we hear from Mr. Summers, some more of our Members have joined us. I don't know whether they have opening statements they would like to make.

Senator Moseley-Braun.

OPENING STATEMENT OF SENATOR CAROL MOSELEY-BRAUN

Senator MOSELEY-BRAUN. Thank you, Mr. Chairman. Thank you very much, Senator Dodd.

Mr. Chairman, I will make my opening statement, then, later on, after other Members have had a similar chance, I have some questions for the Secretary and, possibly, for Mr. Summers.

At the outset, I want to say that I come to these hearings as an original opponent of the Mexican financial assistance proposal, as the Secretary and everyone else in this room is aware.

I opposed the original plan because I thought that investors who had been receiving high rates of return on their Mexican investments should have the exposure to losses that those high returns warranted. After all, the reason the returns were so high is that the investments were risky, and I did not believe that these sophisticated investors should be protected from the risks they voluntarily sought to take.

Having said that, however, I believed then, as I believe now, that it was in the United States' national interest to respond to the financial crisis that occurred in Mexico, and it seems to me that the Administration did what had to be done.

As I understand it, part of the reason we are here today is to look at the past, to consider the decisions made by the Administration and the justification for those decisions. However, I hope that we will now focus on the details of the assistance package now being implemented, that we not lose sight of the critical public policy issues this Committee must face.

The world's financial system, Mr. Chairman, is now integrated to a degree that is unprecedented in our history. While the United States is the dominant participant in the international financial markets, even the United States does not control these markets. London, Singapore, Tokyo, Frankfurt, Paris, Hong Kong, and many other places around the world are not just extensions of U.S. markets that can be completely controlled by U.S. law. Mexico, Japan, Germany, Brazil, Great Britain, and China, are not part of the United States. They are sovereign nations. What happens in Tokyo, Shanghai, London, Mexico City, Cairo, or Capetown, for that matter, however, increasingly affects the markets here in the United States, and there is no going back to a simpler time.

What we need, therefore, is the ability to respond better, with greater involvement of the international community to future financial emergencies around the world.

Make no mistake about it—there will be future international financial situations that will demand quick, coordinated action. The problems that could potentially arise elsewhere in the world dwarf the Mexico situation in their possible impact on the United States economy.

Back in the 1980's, Mr. Chairman, the failure of the then-second largest bank in my State, the Continental Bank, was precipitated by actions taken by money managers in Japan. That, unfortunately, is just one very small illustration of the degree to which the United States financial system and the United States economy generally is tied to international financial system decisionmaking.

I don't know what form greater international cooperation should take at this time, and, frankly, that's a matter of great debate presently in academic circles and elsewhere. I do not know whether or not a new formal structure is called for, or whether closer but more informal cooperation is what is needed.

What is clear, however, is that these are problems that we must address and we must address consistently and in a systematic and sensible way. International financial flows far exceed trade flows, and a significant part of this torrent of money is what's called hot money, money that you move around the globe at the press of a button.

We need to spend some time thinking about the greater degree of volatility in the international financial system and what we and other countries around the world can do to ensure that this volatility does not overwhelm what is fundamentally important to all of us—and that is, maintaining solid economic growth that creates the new jobs that we need and a rising standard of living for our people.

If the Mexico financial crisis and our examination of the United States response to that crisis helps us to develop an ability to respond better to future situations that might arise, then this hearing will have served a very important function. If, however, we use it simply as an excuse for allocating the blame, a 1990's financial version of "Who Lost China?," then I think we will have made a mistake of major proportions.

I hope this Committee will take a constructive route with regard to this issue and that we will help in the formulation of policy and provide some leadership for the debate with regard to our response in future international financial crises.

Thank you, Mr. Chairman, and that's my opening statement. I will also have some questions.

The CHAIRMAN. Thank you, Senator Moseley-Braun.

Senator Bennett.

OPENING STATEMENT OF SENATOR ROBERT F. BENNETT

Senator BENNETT. Thank you, Mr. Chairman. I had not thought to give an opening statement because I didn't want to interrupt the flow here, but the temptation is overwhelming and I will succumb to it.

As you know, Mr. Chairman and Mr. Secretary—Mr. Secretary, we welcome you here—I was originally supportive of the Administration's decision to use the Exchange Stabilization Fund to try to solve this crisis because I felt it was a significant enough crisis that we couldn't turn our backs on it.

I was very dubious of the original proposals that we do something through Congress and I urged the Administration to see if they couldn't find some alternative, and the Exchange Stabilization Fund was the obvious alternative.

As you also know, I was critical of some of the ways the Exchange Stabilization Fund was used, or at least of the announcements of the ways it would be used at the time that came to pass, because my principal concern had to do with stabilization of the currency.

I'm one who believed that the devaluation was a mistake, that we should have done everything we could have as early as possible to prevent the devaluation. For that reason, I'm most encouraged, Mr. Secretary, by your comment about the stabilization of the peso, that it has not spun off into outer space the way it did in the decade before. Not to interrupt the flow of your handoff to Secretary Summers, but you talked about it stabilizing 23 percent. Instead of giving us percentages, can you give us a number?

Where is the peso today with respect to the dollar?

Secretary RUBIN. Yes. Senator, I think, at its weakest, it was roughly 8. Did it get a shade over 8, Larry?

It was roughly 6.11, 6.10, or something like that, yesterday.

Is that about right?

Mr. SUMMERS. By the end of the day, it had gotten very close to 6, yesterday. I don't know where it is this morning.

Senator BENNETT. So it has traded in the narrow range of 5.9 to 6.1 for how many months now?

Mr. SUMMERS. For the last 2½ months. It's traded in a slightly wider range than you suggested, from about 5.7 to about 6.3, but around 6. For the past month or so, it has been somewhat above 6, between 6 and 6¼.

Senator BENNETT. It's the classic good news and bad news.

I recall the conversations during the time when we entered into this whole thing, that there was an expectation, or at least a hope, that it would go from 3.5 to 4, and no worse than 4.5.

The bad news is that it stabilized not at 4.5, but at 6. The good news is that that's down from 8 and the predictions of 10, 12, and whatever we were looking at.

So, that does provide me at least with a sense that we have achieved, if not at the level we wanted, we have achieved a degree of stability in the Mexican situation that was very much in question when this whole thing went into effect.

That I find very comforting. As I say, we can sit down, and we have, Mr. Chairman, we have sat down in my office and talked about this, about ways in which we could reverse a little more of the devaluation if possible. But the very fact that we have achieved a level and maintained that level for a sustained period of time is, to me, the most encouraging of all of the items that the Secretary has talked about.

So I welcome these officials of the Treasury here and appreciate their candor and their willingness to share with us their evaluation.

I won't interrupt any further in the flow of the questions.

The CHAIRMAN. Thank you, Senator.

Senator Dodd.

OPENING STATEMENT OF SENATOR CHRISTOPHER J. DODD

Senator DODD. Thank you, Mr. Chairman. I appreciate your graciousness in giving us a chance to make just a couple of comments and I apologize to our witnesses and my colleagues for being a few minutes late in getting here.

I want to join with my colleague from Utah in commending the Secretary and Mr. Summers for the work that they've done. I've got to try to put this thing into perspective and remember where we were about 8 months ago.

Eight months ago, we were looking at a serious, serious crisis, as the Senator from Utah has pointed out, a crisis that absolutely, without any question, warranted a response. When you had the peso in free-fall and losing value at roughly 50 percent in relationship to the dollar, capital flight at record levels, and a stock market in Mexico that was under siege, it clearly warranted a response.

As I guess all of us recall, obviously, the President felt we should do something about it and asked all of us to get involved in it. That wasn't going to work, for a variety of reasons.

To their great credit, in my view, Senator Dole and Speaker Gingrich, to some degree at their political peril, stood up and said that this was the best answer, at least of what was available as an answer. They may have chosen other routes, but, given all the circumstances, that using the Exchange Stabilization Fund made sense.

Obviously, there were a lot of statements made at the time. No one could say with absolute certainty how this was going to work out. I think my colleagues will recall, it wasn't just Mexico. As the Secretary has pointed out, we were also looking at Brazil and Argentina.

We were looking at a domino effect, a tumbling effect here that could have dwarfed the Mexican situation. Frankly, I suspect, had we not acted, we would be looking at something like that today, and this could be a far more packed hearing room and we'd have a lot more problems on our hands.

So I, for one, commend the Administration, commend Bob Dole and Speaker Gingrich for their leadership. I commend the Treasury Department for the efforts that they've made.

The best evidence we offer is what Senator Bennett has talked about here. The bad news is it isn't as low as we'd like to see it. The good news is it's stabilized, and, at least over the last, as I've inquired, over the last few weeks, what we're looking at is a trade balance. These indicators as to where things are going show that the trade balance between Mexico and the United States has swung from a deficit of $7.3 billion last year to a surplus of $1.9 billion this year. Certainly, I don't think that would have been the case had we allowed a free-fall to continue.

Inflation is declining from 8 percent in April to 3.2 percent in June, another very positive indication that this is taking hold, interest rates have fallen to 40 percent from a peak of 80 percent in March, and Mexico has been able to resume access to private capital markets, which is a very important indicator of the market's assessment of how Mexico is doing.

We can make all the statements we want. The best indication is how the private market out there is reacting. The fact that Mexico is back into the capital markets and there's that degree of confidence being expressed by those markets is probably the best evidence any one of us can offer to the extent that this is working.

Again, as to the statements about $20 billion and $10 billion, I've always believed we ought to try, any time there's any doubt, to sit down and work these things out with people to make sure that we understand each other.

I don't think anyone had any desire to spend a nickel on this, frankly, and this amount out of the Exchange Stabilization Fund, as the Chairman has pointed out, is unprecedented. We've never had anything like this level.

My hope is—and I wasn't here for his statement, but my colleague from North Carolina expressed the concern about whether we'll be paid back. My hope is that we will, that based on previous uses of this fund, nothing like we have seen in terms of the volume amount here, but the strong hope is, given the indications from the kind of statistics we've seen lately, I hope that will be the case.

I, for one, Mr. Chairman, just want to say that I commend the Administration and the Treasury for taking leadership, taking a high degree of risk, and moving in this direction. Had you not acted, believe me, the criticism would have dwarfed anything you're hearing today about this program.

I just hope it continues to work well and that, hopefully, you will call on us up here any time we can be of help in any way. Let me explain to you that, when there are matters in doubt, we don't have to have hearings all the time. The Chairman can't take the time to do it.

Stay in touch with us on this. I know you have. I've received a number of calls keeping us abreast of what's going on.

We want to help make this work. I'm confident that I speak for every Member of this Committee when I say that to you. Whatever criticisms, it is the unanimous desire of every one of us on this side of the table to be constructive and help to make sure that this comes out as we all hope it will.

Again, I thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Mr. Summers.

OPENING STATEMENT OF LAWRENCE H. SUMMERS UNDER SECRETARY OF THE TREASURY FOR INTERNATIONAL AFFAIRS, WASHINGTON, DC

Mr. SUMMERS. Thank you very much, Mr. Chairman. I'd like to use this opportunity to describe Mexico's economic stabilization efforts and provide more detailed information regarding our decision to disburse $2.5 billion to Mexico last week.

When Secretary Rubin and I testified to this Committee in March, it was clear that a fundamental change in the course of Mexico's policies was required to address a dire situation. Mexico has needed to correct the errors of 1994 that threatened its financial stability and its long-term prospects for growth. It is now going through a painful and difficult adjustment process, but I can report to you that Mexico's commitment to policy reform has resulted in significant progress, and our objectives in supporting Mexico's adjustment are being served.

Mexico's money supply is now down by 17 percent since the beginning of the year. Its budget is now in surplus, a surplus of 2.7 percent of GDP in the first quarter. Mexico is preparing transportation and petrochemical operations for sale and is opening the telecommunications and gas sectors to private investment. The central bank has increased the frequency and breadth of its public reporting, and now publishes information on money market operations daily and key balance sheet information weekly. The bank will soon be making this information available via the Internet.

The results of the economic stabilization have been promising. Inflation is down to 3 percent in June, from its 8 percent peak in April, and is expected to decline further in the second half of the year. Strong export growth and restrained imports have reversed Mexico's trade imbalance much faster than expected. Mexico is managing its dollar debt crisis successfully. Over two-thirds of the $30 billion in Tesobonos have been repaid since the beginning of the year. With international support, Mexico has raised external reserves to over $14 billion, up from $6 billion at the beginning of the year, despite making large repayments of debt.

Markets have responded to the strong policies and the economic adjustments they're seeing in Mexico. The peso has strengthened substantially since March and has stabilized in the general range of 6. Peso forward rates, the market's projection of the exchange rate at the end of the year, have risen almost 40 percent from their mid-March lows. Mexican stocks and prices on Mexican Brady bonds have recovered to levels that they had reached before the crisis. Mexican government agencies and some Mexican banks have regained access to the private international markets. Earlier this week, the government made a strong return to the international capital market. A $500 million offering by the government was raised to $1 billion when demand exceeded the original supply by a factor of more than 3.

At the same time, capital flows have resumed with strength to many other developing countries. The tequila effect feared by many has not materialized. The rally in Brady bond markets in general suggests the risk of contagion from the Mexican crisis has diminished substantially.

Inevitably, given the magnitude of the adjustments that were necessary, Mexico's economy has entered a deep recession. Unemployment has risen sharply. Most observers, however, now expect a resumption of growth late this year or early next year. Indeed, recent reports on the performance by Mexican businesses during the second quarter were more favorable than most analysts had expected. As Secretary Rubin pointed out in his testimony, it is now

very clear that the adjustment will be much less painful and protracted than that which followed the 1982 crisis.

As the recession has deepened, working Mexicans have faced growing sacrifices. Mexico's government has worked to mitigate the impact of the crisis, particularly on the poor. These efforts are backed by $1 billion in lending from the World Bank and the Inter-American Development Bank. Social cohesion has been maintained despite the difficult economic circumstances.

On June 1, 1995, the Mexican government presented a long-term development plan that stresses the importance of long-term savings and investments in human resources, including, especially, basic education, health services, and nutrition.

In our testimony and reports to Congress, we have consistently highlighted the Mexican banking system as a crucial issue. Mexico's recession and high interest rates have left many borrowers unable to repay their loans. The Mexican government has responded to banking problems, along the lines of their agreement with us, with measures to improve regulation and supervision of banks, to encourage new investment in the financial sector, and to close insolvent institutions, without the creation of excess liquidity. We are monitoring the situation in the banking system closely.

There have recently been some encouraging developments with respect to this sector. As interest rates have fallen from over 80 percent to nearly 40 percent, the banks have been able to repay $2.3 billion of the $3.8 billion they had borrowed from the government's dollar insurance fund. The Mexican government has received commitments of $1.75 billion from the World Bank and the Inter-American Development Bank, loans which are conditioned on strong and appropriate regulatory controls and improved accounting standards. Removal of certain limitations under the NAFTA on foreign acquisitions of Mexican banks, as well as recent government efforts to encourage and support bank restructuring, have facilitated the infusion of capital into the banking system. Already, one foreign investor has recapitalized and assumed control of a substantial Mexican institution. Several other such transactions are under discussion.

Treasury is monitoring these banking problems closely, as part of our ongoing efforts to monitor the Mexican economy. We have implemented systems for the regular collection of some 60 categories of information embracing nearly 250 pieces of data from the Mexican government. Treasury staff are in daily contact with Mexican officials and will complete five compliance missions to Mexico in July alone.

With our assistance, Mexico has come a long way. Our decision to disburse $2.5 billion earlier this month recognized that progress. It is also based on the United States interest in solidifying the prospects for Mexico's success and its rapid return to growth. Our disbursement was critical in reducing the uncertainty surrounding the need for Mexico to repay almost $7 billion of Tesobonos during July and August. The continued strengthening of confidence and stability will encourage the private sector inflows that are necessary for the program to succeed and for Mexico to reduce its reliance on official external support.

Our disbursement coincided with that of the IMF's commitment under its $18.9 billion standby arrangement, announced on June 30, 1995, to release an additional $2 billion, adding to the $7.8 billion that they had disbursed in February. The IMF also announced that it would make available $8.7 billion in five tranches over the next year, including $1.7 billion in August, subject to Mexico's continued satisfactory performance. I would also note that World Bank and IDB funding approved in June will add a total of $2.8 billion to Mexico's external resources.

Let me just say on the question of the last disbursement, I sincerely regret any incorrect impression that may have been left in our discussions regarding the availability of the second $10 billion of U.S. support. It was our intention to provide resources on a staged and conditional basis if and when they're needed. For that reason, it was our decision to provide $2.5 billion in early July.

Let me just conclude by saying that Mexico has advanced substantially on the path to recovery, though serious difficulties remain. The U.S.-led international support program fortified Mexico's commitment to right the policy errors of 1994 and to adhere to a disciplined program based upon the fundamentals of sound economic management.

I believe that history will demonstrate that the President's decision to support Mexico was the right one—for security along our borders and in our hemisphere, for our economic security worldwide, and for American jobs.

Thank you.

The CHAIRMAN. Thank you, Under Secretary Summers.

Senator Sarbanes, would you have an opening statement?

Senator SARBANES. No. Thank you, Mr. Chairman.

The CHAIRMAN. OK. Mr. Secretary, in your testimony you indicate that the outstanding stock of Tesobonos has been reduced from $29.2 billion at the beginning of 1995, to $8.9 billion, as testimony to the plan's working.

But haven't we simply taken the United States taxpayer and inserted him in place of the Tesobono holder, because, if you were to look at the money that has been drawn down, we see, literally, all of the dollars from the IMF and the $12.5 billion being utilized in that purpose?

So, now, we have the U.S. taxpayer who has assumed the position of the Tesobono holder, except that we don't get 20-percent interest returns. He's gotten his money, he's been paid off, and we now have a repayment schedule that starts anywhere from 5 to 7 years, which is dependent upon all kinds of good things taking place.

When I hear that things have stabilized, I say, they stabilized because we, literally, have paid off those bondholders.

That brings up the question of why should the U.S. taxpayers have stepped in and paid off dollar for dollar, plus those interest rates, and are we going to continue to do that as the other Tesobonos, the other $8.9 billion—I don't think that's a great accomplishment, one that we should herald.

We are simply taking U.S. taxpayers' money, or the Exchange Stabilization Fund, and repaying the debt that the Mexican govern-

ment was having to pay, and now we're saying, "Well, we'll give you 5 to 7 years to pay us back."

I understand that. It happens if we take dollars from one to repay the debts of another.

How is that an accomplishment?

Secretary RUBIN. Mr. Chairman, I think what's happened to Mexico has been an enormous accomplishment. I think a lot of the credit goes to the courage of the Mexican government. I think the program they undertook was really a remarkably courageous and difficult one.

I think what it now promises to do, although there are certainly no guarantees in life, and this still has to work itself out, but it certainly promises, in our judgment at least, to put Mexico into a sound financial position.

So I think I would characterize what happened somewhat differently than you did.

What you had was a situation with $29 billion of Tesobonos outstanding and, in our view, Mexico a day or two or three away from default, which in turn would have had all sorts of ramifications which we discussed in our testimony.

What you have now, instead, is about two-thirds of those Tesobonos retired. You have greater reserves in Mexico. You have debts outstanding to the U.S. Government, as you said, but you have debts outstanding from a country that will have relatively low debt ratios by international standards and, in our judgment, will be a credit-worthy debtor.

I think the probability of our getting repaid is overwhelming. Furthermore, you have debts that are backed up by the oil mechanism which we've discussed at prior hearings.

I think what essentially has happened is you've taken a situation on the verge, and I mean, literally, a few days away from, on the verge of default, and by stretching out short-term debt, which is the way that these kinds of situations, private or public sector, are ordinarily dealt with, you have converted—you are very close to having converted it into a truly credit-worthy borrower, with debt outstanding to the United States, which we not only get repaid, but on which we will make a profit.

The CHAIRMAN. I guess the issue comes down to, how can you determine what the creditworthiness of Mexico will be in 1998, when it has to start to repay these dollars?

We can speculate, but I think it's risky. I think it's very speculative and I still have trouble. There are some questions which I will submit for the record that raise the same issue from Senator Boxer—how is it that we came to bail out sophisticated investors and why weren't there limits placed, in terms of the repayment schedules, requiring them to keep some of their money in the economy, as opposed to taking it out?

But reasonable people can speculate. That's what I'm very much concerned about.

I'm going to ask one other question before I run out of time. This question is addressed to Mr. Summers.

The fact is, on February 21, 1995, when the announcement was made as it relates to the support and the program, we indicated, and I quote here from the document, "The remaining $10 billion

will be undrawn"—that's not semantics—"but available for contingencies, including any related to the banking system."

Then, in your testimony, in March 1995, to the House Banking Committee, again, "The plan calls for using about half of the resources." You're literally restating what was put out in the initial representation, making available holding the other half for contingencies.

What contingency? What contingency took place that would require going forward with putting out $10 billion? Were there monies that we thought we could get from other sources that did not materialize?

I know, for example, one country pledged $1 billion. I know some of the Latin American countries. Are those the kinds of contingencies and shouldn't we have been told about them?

Mr. SUMMERS. Senator, as I said, I very much regret any misimpressions that were left by the statements I made or by the statements that any other Treasury officials made.

I think, in retrospect, the word contingencies may have been poorly chosen.

We recognized all along that this was going to be a situation in which there was going to be a lot of uncertainty and that it would be necessary to provide support if Mexico was meeting the right conditions, if the resources were needed, and if the program was working.

The CHAIRMAN. Did you expect them to do better?

In other words, you say if the program was working. Did you expect them to do better than they have and, therefore, because they haven't done better, you had to draw down?

You keep saying, we have indications, in talking to staff, our staff, we were told we're not going to draw down. It's our hope that we're not going to have to.

It was your hope. Based upon what? Were there things that took place you didn't contemplate that led to the necessity of beginning to draw this down?

Mr. SUMMERS. I would say very broadly, Senator, in the period immediately after the program was announced on February 21, 1995, that the market did not respond in the way we had hoped.

There was much more evidence of continuing capital outflows. Interest rates in Mexico rose much higher. The peso deteriorated much faster than we had expected or hoped.

From some point in mid-March, when the situation was most serious and looked most ominous, the situation has improved and I think, from that point on, it's actually been somewhat better than we would have expected.

The CHAIRMAN. Can you be a little more specific, because we are talking about lots of money?

What are we talking about? Employment? Did the employment picture deteriorate more than anticipated? Were interest rates or problems with small banks, or with the Mexican banks, greater than was anticipated?

Mr. SUMMERS. I think, in the period of the first month following the announcement of the program, that many of those things were worse than was anticipated. But, in particular, the flow of capital

out of Mexico was greater than expected and the flow of private capital into Mexico was less than expected.

After that, the situation improved quite substantially and, certainly, the response has been better since mid-March than most market observers or, indeed, we would have expected at that point. I think people in the markets, commentators in general, have been struck by the speed with which Mexico has been able to return to the private market.

The CHAIRMAN. My time is up and I have my colleagues here, but I want to return to that question about where the economy is and what is taking place.

What is taking place in real terms? I'd like you to give us an analysis in terms of jobs, if the employment situation is improving or deteriorating? What can we look forward to in the near-term? Are they going to be able to redeem these Tesobonos, or are we going to have to continue to redeem them?

I say "we" because it seems to me that we're stepping in in place of the Tesobono holders.

Senator Moseley-Braun.

Senator MOSELEY-BRAUN. Thank you, Mr. Chairman. I, because I don't know what the time is going to be for the Secretary today, and I know this is a complex issue and one that we're going to spend some time with, I would like to really almost digress, but to raise what I think is a very, very important issue, close to home for the Secretary.

I know that, as a matter of fact, I've heard from some of his people on this, but I wanted to get the chance to raise it with him directly.

It has to do with something closer to home, specifically, what happened in and about Knoxville, Tennessee this last week regarding the good-ole boy roundup and the possible complicity and involvement of the BATF and, possibly, other Treasury officials and employees in that event.

I don't know if you're aware of it, Mr. Chairman, but there were reports this week in the paper regarding a party, an annual picnic, at which some 300 law enforcement members and their families attended. It turned out to be a racist orgy in the process, with racial slurs on T-shirts, such as Dr. Martin Luther King's face on a target and, I guess, Nigger Check Point, and all kinds of just really obnoxious and abhorrent racial statements, slogans, flags, and the like. The BATF was involved.

Since we have the Treasury Secretary here—I know that Mexico is important, but Knoxville, Tennessee and the United States is more important to me, at least—I wanted to take this opportunity to raise the issue with the Treasury Secretary and to find out what has happened and what plans, if any—and I hope he does—the Secretary has with regard to addressing the involvement of Treasury employees in this matter.

Secretary RUBIN. Senator, I very much share your reaction.

We have condemned the action. I will speak for myself, personally. I think it is absolutely reprehensible.

There were about 300 people there. John McGaw, who is head of the ATF, had first heard about this about 3½ weeks ago, I believe, and he immediately began an investigation.

It is our present impression that a very small percentage of those 300 people were ATF people, but even if one was, and there clearly were more than one, even if one was, it is reprehensible and we absolutely condemn it.

The investigation should be done in a reasonably short order. We will take all appropriate actions possible with respect to the people who were there. We will also immediately come back and confer with Congress and discuss with Congress the results of those investigations.

I have asked our Under Secretary for Enforcement, Ron Noble, to speak to the other enforcement bureaus at Treasury, to determine whether any of their people were at this same gathering.

I totally agree with your reaction. It is absolutely reprehensible. We totally condemn it and will take all actions that are within our purview to deal with the people who were there.

Senator MOSELEY-BRAUN. I appreciate that, Mr. Secretary, and I knew that's what your response and reaction to this really outrageous situation would be.

I would also, however, raise the question with you regarding Treasury, generally, because, as you are aware, there are presently lawsuits regarding discrimination pending by minority members of Treasury of the various Departments in Treasury, specifically, the ATF, and whether or not you would think it appropriate, given this kind of situation and track record, or at least the allegation, whether you would think it appropriate to have an internal review of complaints of discrimination and the like within the BATF or other agencies of the Treasury.

Secretary RUBIN. Senator, I think we are very conscious of the importance of being totally nondiscriminatory in everything we do.

I've been involved in managing large organizations for a long time and there will always, I think, be problems in this area. It's an inevitable part of institutional life.

Sometimes allegations are well founded, sometimes they're not.

I think we take all allegations with great seriousness. I think that we have in place appropriate processes for reviewing and dealing with these matters, but I would be delighted, when I get back to Treasury, to discuss this with people there and report back to you.

If we think anything further should be done, then I certainly think we should do it.

Let me first sit and talk with the people there and determine whether we feel any additional measures are necessary.

Senator MOSELEY-BRAUN. I very much appreciate that. I would also say to you, Mr. Secretary, Ron Noble did call. He was right on this issue. I am aware that you are taking appropriate steps with regard to the picnic, specifically, but I think it might be appropriate to take the next step and take a look at what is going on that creates a climate in which this kind of activity, in which members of an agency of law enforcement, no less—it would be different if it were just private citizens or whatever, but these are law enforcement personnel in an important Federal agency.

I think the climate in that agency is a very important indicator of how these things may be viewed and the level of encouragement

or support that this kind of reprehensible conduct might get from within the agency.

So a review would be appropriate, I think. But I would certainly be delighted to wait until you've had a chance to talk with your people and get back to me specifically about it.

Secretary RUBIN. Let me assure you of one thing, if I may, Senator.

With respect to Treasury as a whole, I think there is a very constructive and positive view with regard to these matters in Treasury as an agency. It's something we have focused on since I've been there, but I know it's been focused on at least through its recent history, the history that I'm most familiar with.

In terms of the ATF itself, I think we do need to know more about exactly what happened, who was there, how many people were there, and that is the purpose of the investigation.

I think it is our present impression that we will find that a very small percentage of those 300 people were ATF people and that a very, very small percentage of the people at ATF were at this picnic.

There are a lot of people in ATF, Senator, who do extraordinarily dangerous jobs. They deal with some of the most dangerous criminals in America. Something like 30 percent of their arrests are of armed drug traffickers. These are very difficult, very dangerous jobs.

Having said that, what happened in Tennessee was reprehensible. We condemn it totally. I personally condemn it totally. It is the antithesis of everything I believe in, and we will deal with it.

Senator MOSELEY-BRAUN. I thank the Secretary and say to you, I recognize that. I come out of a law enforcement family. Law enforcement organizations are very sensitive organizations. They do very dangerous work.

But, at the same time, where you have this kind of a rotten apple in the barrel, it's important to go after it and to make certain that it doesn't contaminate all the good work that people do or anything else.

Again, I look forward to hearing from you and I want to, for the record, to thank you personally, Mr. Secretary, for visiting Chicago and the people there. Everyone was just thrilled and delighted with your presentation and the discussion that you had.

So thank you very, very much for your support and for coming out and talking to the folks back home for me.

Secretary RUBIN. Thank you, Senator.

The CHAIRMAN. Senator Bennett.

Senator BENNETT. Thank you, Mr. Chairman. First, let me pursue, and the answers can be brief because I want to get to a second issue, but let me pursue a summary of the position that I took last February in support of the use of the Exchange Stabilization Fund.

I would say to the press, when they would question me about that, I had three conditions. You seem to have touched on this today, but I want to nail this down.

Number one was transparency. We did not know what was going on in the Mexican economy. Reports were coming out, 90 days of economic activity, but the report would be 30 to 60 days late after the 90 days were up.

Can I correctly assume, Mr. Summers, your testimony is that we are indeed getting the daily data that we demanded last February?

Mr. SUMMERS. Yes.

Senator BENNETT. OK. The number two condition was the independence of the central bank. We got into this trouble, or the Mexicans got into this trouble partly because they had a Presidential election and the party in power told their version of the Federal Reserve, we want you to increase the money supply in order to make things look good so we'll win the election.

Their independence was on paper, but was not real.

Would you now say that there is indeed a genuine independence of the central bank and that they can stand up to the government and say, this is what we need to do?

Mr. SUMMERS. The central bank is independent. It is clear from our discussions with central bank officials and with ministry of finance officials that the central bank is indeed acting independently in its pursuit of price stability.

Senator BENNETT. The third condition, which I touched on in my opening statement, we've talked about. I was very anxious to use these funds to help shrink the money supply and made very specific recommendations which the Treasury, in its wisdom, decided to consider carefully. I accept that, but go a slightly different direction.

You used it primarily to retire Tesobonos, which had the effect of shrinking the money supply, but not as directly as I might have wanted you to. Nonetheless, you did shrink the money supply.

Now, in your testimony, you say that it is 17 percent less. Is that 17 percent baseline less than it was prior to the devaluation? Seventeen percent less than when?

Mr. SUMMERS. It's either the January 1, 1995 figure or the December 1, 1994 figure. I don't remember which. The devaluation took place in mid-December.

It's less than the January 1, 1995 figure, so at the beginning of the year.

Senator BENNETT. So I can assume that it would be less from the point of devaluation?

Mr. SUMMERS. Yes. Yes.

Senator BENNETT. Maybe even more than 17 percent from the point of devaluation. I guess the money supply would have grown from January to February, but all right. That's a quibble.

Mr. SUMMERS. We will furnish you with the numbers for the record.

Senator BENNETT. All right. That would be helpful.

I'd like to go to the point the Chairman was raising with you and approach it from an accounting standpoint. This may be an oversimplification, but that's the way I can understand things.

We have put in, or the international community has put in X-billion dollars. As I've listened to your testimony, I've written down something in the neighborhood of $20 billion—$10 billion from the United States and $10 billion from the IMF; $7.8 billion in the beginning and they've added an additional $2 billion.

Have I missed any? We don't need an exact figure.

Mr. SUMMERS. Prior to July 1, 1995—it's actually $12.5 billion from the United States, Senator, and about $10 billion from the

IMF, with the $12.5 billion including the last $2 billion from the United States.

Senator BENNETT. OK. So from external sources, external official governmental sources, roughly $22 to $23 billion has been inserted into the Mexican economy. That's on one side of the ledger sheet for an accountant.

How much has stuck? In other words, you've said that the Mexican reserves are up. Other things are up. I can't come up with an exact figure there. I'm assuming that it is less than $22, $23 billion. I think that's what the Chairman is getting at.

If we're substituting, we're substituting external governmental funds for other funds, how much has stuck and how much has flowed through in the disastrous collapse of the Mexican economy?

I wouldn't expect all of it to stick. If all of it would stick, then they didn't need it.

Mr. SUMMERS. I hope this will be helpful in answering your question, Senator.

The reserves the Mexican government and central bank had at the beginning of the year were about $6 billion. At present, they're just in excess of about $14 billion.

So, in those terms, $8 billion has stuck, to use your term.

Senator BENNETT. Yes.

Mr. SUMMERS. The remainder has obviated the need to print pesos and purchase dollars which, otherwise, would have been inflationary.

Senator BENNETT. Yes. As I say, I wouldn't expect all $22 billion of it, but I think that's the point the Chairman was getting at, that we've got to see some of it begin to stick or we, in fact, are kidding ourselves that we've stabilized the situation, because if you put in $22 billion and none of it remains, then the indication is you're going to have to put another $22 billion in, and there we go.

If it is beginning to accumulate now, that, to me, is a fairly good indication that things really are as good as you're portraying them in your testimony.

Mr. SUMMERS. Senator Bennett, let me cite one indicator, that wasn't referred to in our testimony, that I think corroborates what you're saying.

Each week, the Tesobonos come due and investors are given their choice between asking for dollars and redeeming those Tesobonos for pesos.

The fraction redeemed for pesos fluctuates, but it has, in general, tended to trend upward in recent months. Although it fluctuates a lot from week to week and is running around 40 percent, those who could just get dollars and close out their investment are now choosing to get pesos.

In the early stages, last March, at that stage, that fraction would have been much, much lower, quite close to zero.

Senator BENNETT. OK. My time is up, but I just want to leave you with this thought in the same vein, I think, as Chairman D'Amato's questions.

That is, one of the things we ought to watch, just to restate my concern, is how much of the money we put in sticks in the stability of the Mexican circumstance, instead of being simply flushed through.

I would anticipate, in the moments of crisis, there's really nothing you can do to prevent the money from flushing through, but if the actions that are being taken are, in fact, going to work, increasingly the money will begin to stick within the Mexican system and the reserves will begin to grow and, then, the successful Tesobono auction will begin to put $1 billion back. Here's $1 billion that we didn't put in that's sticking. It's $1 billion that is coming out and, pretty soon, we will see there is a balance and we put $22 billion in and there's $22 billion sitting there that has accumulated.

That's an accountant's way of saying, this program is working.

Mr. SUMMERS. Senator, let me say in that regard, and we will furnish some statistics for the record, that, whereas, of the $22 billion we have put in, $8 billion has stuck, as you're using the term.

If we ask the question as of April 1, 1995, of the money that was put in after April 1, 1995, I think we would discover that a much higher fraction has stuck, and that there have been periods of several months in which the reserve increase has been just about equal to the infusion of funds from official sources.

So there have actually been periods of 2 months, a month to 2 months, when, essentially, 100 percent of the resources that were put in stuck.

If you look at exactly the criterion you use, the fraction that is sticking, that is staying in, that is not having to go to pay out Tesobonos is consistent with the fact that it's succeeding, that fraction has steadily increased.

Senator BENNETT. I think that's the point the Chairman was trying to make, that we've got to be sure it isn't just flushing through, that it is hanging in there.

I would hope that you would continue to monitor that number.

The CHAIRMAN. Senator Dodd.

Senator DODD. Thank you, Mr. Chairman. I have three or four questions that I'll try to cover very quickly, if you can try to just give me some brief answers. I will address them to either of the witnesses, whichever of you would like to respond to them.

I wonder if you might try to describe for us briefly here why the package of the $20 billion was fashioned in the way it was?

Questions have been raised about the latter, the second $10 billion, based on contingencies. The first $10 billion was up-front, then, the staged release.

Why was that the case? This might be obvious to you, but I don't think it is to others. Why are we in this situation regarding the second $10 billion?

Secretary RUBIN. Senator, the concept from the very beginning had been that what we should do is to provide the resources in a tranched basis, just as the IMF provides their funds in a tranched basis.

Once Mexico had committed themselves to a program—and they made this judgment themselves. It was, as I said before, a politically courageous set of judgments to make, but once they committed themselves to the very rigorous program they did, then we supported that with our conditionality. The concept was to release tranches over time if they continued to meet their commitments, which they have.

It had always been our notion that the odds, the probabilities were exceedingly high that they would need the first $10 billion. I think the basis, the reason for this confusion, Mr. Chairman, it had always been our view that the first $10 billion would almost surely be needed. The question was how much of the second $10 billion would be needed.

At various times, I have press releases that we put out here, we've always said $20 billion would be available if needed, and we've had various ways of referring to that. At least in our own minds, we sometimes refer to the second $10 billion as a contingency fund.

That is to say, if, after the first $10 billion, it still looked to us that, A, they were meeting the commitments, B, it was needed and, C, the program was working, then, with those conditions having been satisfied, we would advance additional funds.

It was never our intention to think of contingency as meaning emergency, and I think maybe, Mr. Chairman, that is where the confusion has arisen.

That is exactly the program we have followed. We get an enormous amount of information on a daily basis, and we have released the funds on that tranched basis.

Senator DODD. If you would, jump to the funds provided by the IMF, roughly an equivalent amount has been committed. I wonder if you might describe the nature of the IMF assistance and what conditionality is associated with that assistance.

Mr. SUMMERS. The IMF disbursed $7.8 billion at the beginning of February on the basis of a program with a set of targets on the money supply, the budget surplus, credit, and so forth.

At that time, they announced there would be a review of the Mexican situation prior to July 1, 1995, and that they would then negotiate a program looking forward from July 1, 1995.

They carried out that review during late May and June, found that the Mexican economy was performing well, given the circumstances, and that the policies were appropriate, and they then committed—the IMF, with its money, operates in a somewhat different way than ours, in the sense that they announce a specific schedule of disbursements that are available subject to conditions.

They announced $10.8 billion to be disbursed in six tranches. The first of those tranches of $2 billion was disbursed at the beginning of July.

The next tranche, which is $1.7 billion, is scheduled for disbursement, to be available to the Mexicans, assuming they meet the conditions after a review, in the latter part of August.

Then, there are four more tranches of $1.7 billion each, subject to a review, spread out through the first half of 1996.

Senator DODD. What sort of conditionality is the IMF placing on Mexico that may be different from the conditionality that we—or is it basically the same?

Mr. SUMMERS. Our conditionality builds on the IMF conditionality by addressing issues like transparency of the central bank and the data, by addressing issues relating to privatization, and by elaborating the need for strict credit policies to prevent an excessive exchange rate depreciation.

But the conditionalities are consistent, and the specific numerical conditionalities on the budget surplus and the like are the IMF's conditions.

Senator DODD. To what extent is the involvement with the Fed? Are they being consulted? Are they approving of this, the actions being taken?

How much are they involved? To what degree are they involved with this?

Did they approve of, for instance, this last $2½ billion?

Secretary RUBIN. Senator, the Fed has been a very constructive participant and a very knowledgeable consultant, but we have not sought their approval for dispersal of funds.

Senator DODD. Have they agreed with its dispersal?

Secretary RUBIN. I don't recollect discussing this disbursement with the Fed, Senator. Maybe Under Secretary Summers did.

I don't know.

Senator DODD. I realize it's a delicate balance here, and I've asked Chairman Greenspan the question. He doesn't want to be drawn in as a direct participant.

Secretary RUBIN. I think maybe a better way to put it is this.

The responsibility for these judgments rests exclusively and solely with Treasury. The Fed has been extremely helpful as a consultant.

Senator DODD. Let me put it this way, in the negative. Did they object to this? Did they disagree with the last disbursement?

Secretary RUBIN. I don't recollect having discussed it with Chairman Greenspan, Senator, but I may have. I see him with some frequency and it may have come up, but I don't recollect a specific discussion of the disbursement.

I don't think there's any question, though, that the disbursement is consistent with the criteria we have had all along. As I've said now a number of times, I think we are well on our way to a success in Mexico, though there are no guarantees.

Senator DODD. I appreciate that. The red light is on and this will be my last question, so I won't take any more additional time.

I'd like you to share with the Committee what we've learned from this. Hopefully, we're never confronted with this kind of situation again. But I think it's probably unrealistic to assume, at some future point, there may be other places in the world where there will be other crises like this and there will be demands on—whether it's on us, the G–7, the G–8, or the IMF.

Should we institutionalize some process that allows for this kind of thing? If you do that, does it become a fund that people then say, "Well, instead of dealing with the problems on our own, we can always go to this kitty," whether it's our kitty or an international kitty?

Does it become a self-fulfilling prophecy, with a set amount like $20 billion, that becomes automatically a conclusion that there's a drawing down of that amount in the process?

Maybe you want to respond to this at greater length in writing at some point, but, if you might, would you just take a couple of minutes and share with the Committee what we might be looking at, what this Committee might be looking at.

Should we be talking about instituting something here that would provide a systematic way to approach this, rather than going through the gymnastics that we did back in January, February, and March, of Congress and the leadership bickering back and forth, because, like natural disasters, I presume that we're going to be facing some of these again at some point in the future?

We might as well learn from these lessons, if we can, in terms of how we might deal with them.

Secretary RUBIN. Senator, I think that's a point exceedingly well taken.

I think the short answer is that the initiatives we went to Halifax with were really a function, in some fair measure, of the Mexican experience. There were lessons drawn from Mexico.

Basically, we went with measures like transparency, that we feel would be preventative, and with suggestions for an enhanced international capability so that we will not have to be, as we cannot be, the lender of last resort, and this can be appropriately shared on an international basis.

As we work these measures through with our G–7 and other colleagues, we will then be coming back to this Committee for, I think, quite extensive discussions of these matters, but we would also be delighted, if you like, to——

Senator DODD. I think it's very important to do that. I don't know if the Chairman agrees with me or not, but, obviously, I'd like to see that happen.

I have to tell you quickly a cautionary note. I get nervous about the idea of creating these funds and then having the countries that get into these situations saying, "Well, we don't have to worry about it because there's a fund out there."

Secretary RUBIN. But, Senator——

Senator DODD. Another thing, I don't want to have a system in place in which we don't have a way to respond. I'm torn as to how you approach it.

Secretary RUBIN. The answer to that moral hazard question is that I don't think another government is going to want to experience what Mexico has gone through. Any body of money that was created as an enhancement of the IMF capability would still have to be subject to strict conditionality with all of the very grave disadvantages to the subject country involved in incurring those conditions.

Senator DODD. I'm sure they don't anticipate or want to go through it, but we all, whether it's bad leadership, bad decision-making, these things happen.

I don't have an answer for it. I just raise the question of problems we may face as to, one, needing some ability to have a systematic response and, two, as I'm fearful of having it, then getting countries that avoid doing the kind of tough things that Mexico now is doing, to their great credit, in my view, to solve their problems and get back on track again.

I think there needs to be a good healthy discussion about this in light of this particular problem. Too often, we go through these things and then we move on.

Whether it's this Administration or another one that comes down the pike that's calling people and asking, "What did you do 5 years

ago, 10 years ago, on these issues?," I would hope that we might give some real thought to this. There needs to be, I think, a public debate and discussion, at least in the context of the legislative branch, and some sort of discussion about the kind of commitments we ought to be making internationally as to the wisdom of setting up these funds.

I've taken more time than I had intended, but I wanted to raise that.

The CHAIRMAN. I think, Senator Dodd, you have touched on something that is very important.

I find the concept one that I share some anxious concerns about. You've touched on it. I think you've done it with good balance. While there may be a need, do we now set up a fund with, again, substantial contributions from the United States to deal with situations and, indeed, encourage them?

If we're talking about free market operation, I think there has to be a recognition that we don't step into a situation where people are making investments and taking risks that went sour.

We don't have that mechanism here in this country. I have to tell you, even with all of this information you're giving me about emerging markets, I think there's a problem I still have with what we've done, and I'd hate to see us now begin to commit to even larger commitments world-wide.

I'm concerned about it, and I think your suggestion about beginning to look into this issue sooner rather than later is an excellent idea. We can have these discussions in a frank and candid manner and have an exchange on this.

What should our role be? Where should lines be drawn, so that we understand?

It may be absolutely essential when we're talking about currency stabilization to have a fund like that, but do we substitute taxpayers' dollars where you have a deteriorating economic situation? There may be somewhere where it's justified. Currency speculators today can do incredible things.

Should we have some mechanism where we find that there are various forces throughout the world operating in such a manner as to make billions of dollars and create economic chaos?

So I think that's an excellent idea and I think I'm going to ask our staffs to work together with the Ranking Member, Senator Sarbanes, to set up a schedule of hearings so that we can look into this. It's an excellent idea.

I know some of the Members have requested a 5-minute break and I think the Secretary has some phone calls he has to make. We're going to take a 5-minute recess and resume with Senator Faircloth.

Secretary RUBIN. Thank you, Mr. Chairman.

[Recess.]

The CHAIRMAN. As I said, we will resume.

Our distinguished Senator from North Carolina, who has patiently been waiting to ask his questions, we turn to Senator Faircloth.

Senator FAIRCLOTH. Thank you, Mr. Chairman. Before I start with my questions, as I spoke very briefly to Secretary Rubin a few minutes ago, first, I want to say to both of you that I truly appre-

ciate the public service that you're rendering to the country and the abuse that you take for whatever it might be, the problems of dealing with a group of Senators with totally diverse views and different ideas, and each of us 100 percent confident that we couldn't be wrong.

Again, I was against the Mexican bailout in December, March, and July. I think we never should have been there.

Every election, 1982, 1988, 1994, they've come to the Exchange Stabilization Fund for money and they have paid it back so far, but I am thoroughly convinced it's like a con game at a carnival. You win three small bets and you lose the big one. I believe that's where we are going now.

I believe it was you, Mr. Summers, who said that the Mexican exports had grown. Big growth, nice growth in Mexican exports.

Number one, would that have come about by the loss of roughly half the value of the peso? If that's true, what effect has that had on Mexico as a NAFTA trading partner?

Mr. SUMMERS. Senator, because the supply of capital to Mexico dried up and they weren't able to attract finance in the way that they had been, the trade deficit that Mexico was able to run, they stopped being able to run because they couldn't attract the finance on a continuing basis.

So, in that sense, they are not making as large a contribution to their economy as they were.

I think by investing and helping them to get back on their feet, we are hastening the day when they will again be a source of major export growth for the United States and we're avoiding the kind of thing that happened in the 1980's, which was really quite damaging for our economy in terms of a very sustained contraction in the region that was closest to us.

Since you mentioned the NAFTA, I would also make the point that the NAFTA showed something in the fact that Mexico, in the wake of this episode, raised tariffs against all its other trading partners, but did not raise tariffs against the United States and Canada because it was literally prohibited from doing so by the NAFTA.

Senator FAIRCLOTH. You said that 40 percent, roughly 40 percent of the people that could accept either dollars or pesos on the Tesobonos, and they had the option, but about 40 percent of them were taking pesos.

I don't know whether that's saying good for the peso or bad for the dollar, but would you explain to me why a currency that's losing 3 percent of its value a month, why a sound investor would take that currency rather than the dollar, or is there something going on with the dollar that we don't know about?

Mr. SUMMERS. Senator, I think the main answer to that question is that interest rates in Mexico are in excess of 40 percent.

Senator FAIRCLOTH. I'm sorry?

Mr. SUMMERS. Interest rates in Mexico are in excess, are greater than 40 percent.

Senator FAIRCLOTH. I understand that.

Mr. SUMMERS. So, even if you think the peso is going to depreciate a little bit, or even a certain amount—suppose you were an investor who thinks the peso is going to depreciate 20 percent over

the next year, then, if you take pesos, invest the money in peso paper, earn a 40-percent interest rate, and convert back to dollars at the end of the year, even with a 20-percent depreciation of the peso, you will have earned a 20-percent return.

So I think the judgment of investors is that Mexico, by maintaining high real interest rates to attract capital, the judgment of those investors who keep their money in pesos is that the level of interest rates in Mexico more than compensates them for the risks associated with the possible depreciation of the peso.

Clearly, the objective of Mexican economic policy, and it has succeeded to some degree so far as evidenced by the fact that interest rates have come down from 80 to 40 percent, is to get to a situation where there is more confidence that the peso will not continue to depreciate and, therefore, people will be continuing to invest in Mexico at lower interest rates.

I think the key to that is bringing down the rate of general inflation in Mexico. That's why it's very encouraging that the rate of general inflation has come down from 8 percent a month to about 3½ percent in June, and people are looking for it to get to 2 percent, or possibly even slightly less, in the second half of the year.

Senator FAIRCLOTH. Aren't the reasons for taking the peso that they're betting the inflation will drop in Mexico?

Mr. SUMMERS. That's right.

Senator FAIRCLOTH. OK. I hesitate to comment on something that Senator Dodd said, and this is really a comment, when he's not here to respond, but it requires no response. He certainly is probably right, but I believe diametrically opposite, that the worst thing we could think about doing is participating in or creating some sort of fund to bail out countries around the world that get into trouble.

I think that simply encourages getting into trouble. I think rather than creating a fund to bail out potential currency problems around the world, it might be a better policy to state flat, cold, and now, that, once we get out of the Mexican fiasco, we don't ever intend to enter another one with the American taxpayers' dollar.

One other thing. I do not believe, and we will never know, if we had not entered into the Mexican financial crisis, that it would have expanded to other nations.

I don't think it would have. I don't think you had the domino effect. I don't think the Mexican economy had that much of an influence on the rest of the world that it would have created a domino effect.

I just want to state a personal opinion that I think, rather than thinking about creating a fund, we should issue a firm and cold statement that we don't intend to participate in any more bailouts around the world.

I thank you, Mr. Chairman.

The CHAIRMAN. Senator Sarbanes.

OPENING COMMENTS OF SENATOR PAUL S. SARBANES

Senator SARBANES. Thank you. Thank you very much, Mr. Chairman. I want to join my colleagues in welcoming Secretary Rubin and Under Secretary Summers.

I'm not exactly clear how much money is going into Mexico from other sources, other than from the Treasury fund, in order to help to accomplish this.

The IMF has committed how much? Could you just review that for me?

Mr. SUMMERS. The IMF has committed a total of $18.9 billion, of which $9.8 billion has so far been disbursed, and the remaining $10.1 billion is scheduled to be disbursed in a series of——

Senator SARBANES. The remaining $9.1 billion.

Mr. SUMMERS. Excuse me, Senator. I do mean $9.1 billion. The remainder of the money is scheduled to be disbursed in five further tranches throughout the year.

Senator SARBANES. Are they committed to doing that? What's the nature of the commitment on the further tranches?

Mr. SUMMERS. Mexico and the IMF have negotiated a program. The IMF is committed to making those disbursements, assuming that they are requested by the Mexicans and assuming that Mexico is in compliance with the conditions under the IMF program which go to the money supply, the budget surplus.

Senator SARBANES. Are we committed to making any further disbursements from the Exchange Stabilization Fund beyond the $12.5 billion that we've already made?

Mr. SUMMERS. No, Senator, we are not committed.

Senator SARBANES. Is the IMF commitment of the additional $9.1 billion, in these five tranches that you have indicated, premised on or related in any way to further commitments by the United States from the ESF?

Mr. SUMMERS. No formal commitment exists between the United States and the IMF with respect to these monies.

We have made clear we are prepared—we would disburse these monies under the three conditions Secretary Rubin has cited, that Mexico be meeting the conditions, that the money be needed, and that the program is working. That is the only assurance we have given.

We have not set any specific schedule for our disbursements, nor made any commitments that we would disburse on any specific dates.

The IMF program for Mexico is like other IMF programs, in that it embodies a schedule of specific disbursements on specific days.

The commitment we have made is the commitment Secretary Rubin made in his testimony here, that the $20 billion was available, but subject to those three conditions.

Senator SARBANES. So we're a backup, in a sense, to these IMF commitments, as we look ahead now.

Mr. SUMMERS. I don't think that would be the characterization I would use for it.

Senator SARBANES. If there were no need, you'd never reach any further draw on the ESF.

Isn't that right?

Mr. SUMMERS. If there's no need for resources from the ESF, the United States will not make a further contribution.

Senator SARBANES. But the IMF has now taken a commitment that's beyond that, so to speak, by undertaking these tranches.

Is that correct?

Mr. SUMMERS. Yes, although I listed as one of the conditions for the IMF's disbursement of the money that Mexico make a certification to the IMF of the need for that money, but, yes, the IMF is committed if Mexico needs the resources. That's correct.

Secretary RUBIN. Could I add one comment, Senator, just to make sure there's absolute clarity?

On the three tests that apply for our monies, have they met the requirements, is there need, and are they succeeding, those are judgments we make in our sole discretion so that, in effect, while these are the criteria we apply, we make the judgments and that judgment is solely in our discretion.

Senator SARBANES. Now, from what other sources has Mexico gotten assistance?

Mr. SUMMERS. Mexico has received $2¾ billion in support from the Inter-American Development Bank and the World Bank, which will disburse over time, assuming continued compliance with the conditions of those institutions' programs. One and three-quarter billion dollars refers to loans in support of financial sector reform. One billion dollars refers to loans for the social sector.

Senator SARBANES. Anywhere else? Is there any other direct country help?

Mr. SUMMERS. No, sir, Senator. There continues to be available to Mexico a BIS short-term facility which they have not drawn on because their resources are—because the need at this point is for longer term resources rather than the short-term money under the BIS facility or that is also available in a $1 billion swap arrangement.

Senator SARBANES. How much is available from the BIS?

Mr. SUMMERS. The BIS arrangement provides for up to $10 billion in short-term support.

Senator SARBANES. So the United States—even if you take the $20 billion figure, of which you've used $12½ billion, and the rest you're holding back on, even at the $20 billion figure, it's less than half of the assistance package.

Is that right?

Secretary RUBIN. I think, Senator, of the resources that Under Secretary Summers referred to, the resources that are really pertinent to this problem, and we've said this consistently in our testimony before a number of Committees, the ESF money, the IMF money, the World Bank and the Inter-American Development Bank, the BIS money, as the Under Secretary said, is short-term money and really is not structured in a way as to be directly relevant to the problems that we've been dealing with in Mexico.

Mr. SUMMERS. But, Senator Sarbanes——

Senator SARBANES. If you exclude the BIS money, it's still less than half.

Secretary RUBIN. About half, yes.

Senator SARBANES. That's assuming you were to use all of the $20 billion.

Mr. SUMMERS. That's correct.

Senator SARBANES. It would be less than half. Now, if you don't use the $20 billion, the percentage drops accordingly.

Is that correct? The U.S. percentage would drop accordingly.

Mr. SUMMERS. That's correct.

Senator SARBANES. Yes. Now, I want to ask about this foray back into the private capital market by Mexico.

First of all, did you expect commitments of the amount that took place? Did you share the view that this offering would not attract, I gather, close to a $2 billion interest?

Mr. SUMMERS. Senator, at the time it was first undertaken, I certainly did not expect it to be oversubscribed in the way that it was.

Senator SARBANES. What's your explanation for the oversubscription?

Mr. SUMMERS. As it was coming, I was told by Mexican authorities and by others involved that it was going very well. I think it was going very well because people perceived, the investment institutions perceived that the country risk associated with Mexico was declining as its inflation rate came down, as the peso remained stable, and as it became increasingly clear that it would be able to meet its obligations.

To many, many financial institutions the size of the spread, 5⅜ percent over U.S. Government rates, looked to be very substantial relative to the risks involved. So, they were eager to participate.

Senator SARBANES. What does that rate amount to right now, the total rate? It's a floating rate, right?

Mr. SUMMERS. Senator, I'll have to get you that information. It would be, I would guess, I haven't done the calculation, but I would think it would be in the 10 to the 11 percent range.

Senator SARBANES. So 5.375 percentage points over the 6-month London Interbank offered rate would come to 10 or 11 percent?

Mr. SUMMERS. My staff tells me that the number is 11.1 percent.

Senator SARBANES. Eleven point one percent. Are there any special arrangements with respect to repayment or things of that sort with respect to these notes?

Mr. SUMMERS. The notes are 2-year notes and there is a rather complicated set of provisions saying that they are usable in the context of Mexican privatizations taking place during that time, and that the instrument can be redeemed at par in the context of such privatizations.

Senator SARBANES. Would they have been advised to have expanded their offering up to the level of the subscriptions? I know, apparently, they doubled it. I'm not certain about that, but would they have been advised to have gone for the full amount?

Mr. SUMMERS. I think that was a judgment they took in consultation with their private sector financial advisors on the basis of a number of considerations, including being able to maximize their capacity to access the market, not just in one transaction, but going forward.

It was their judgment, weighing the various considerations including the future market access, that the right thing to do was to take twice what they had been hoping for, what they had been seeking, but not to accept all the subscribed offers.

Senator SARBANES. Now, the money that's coming in from the international community and from the United States is all on a repayment basis.

Is that right?

Mr. SUMMERS. I'm not sure what you mean by that.

Senator SARBANES. The $12.5 billion you've put in is to be repaid, is it not?

Mr. SUMMERS. Oh, absolutely. It's to be repaid and to be repaid with an interest rate that is significantly in excess of the government's borrowing costs.

Senator SARBANES. Have the terms of the repayment been set or is that a floating thing?

Mr. SUMMERS. The interest rate is something that will float with U.S. Government interest rates. The maturity, which is between 3 and 5 years, has been set and is according to a fixed schedule.

Senator SARBANES. Is that for the money from the Treasury fund or also the IMF, the World Bank, and the IDB money as well?

Mr. SUMMERS. My reference to 3 to 5 years, floating rate, and a significant premium was to the ESF money. The World Bank and the IDB money is considerably longer term, more than 10 years. I don't recall the precise maturity, but it would be at an interest rate close to the U.S. dollar interest rate.

The IMF money is 5-year money and would be at an interest rate that was close to the borrowing rate for the major countries, which is what comprised the IMF's currency basket.

Senator SARBANES. So the repayment of the principle by Mexico, in effect—the United States, because of the term, comes ahead of the IMF, the World Bank, and the IDB.

Is that correct?

Mr. SUMMERS. The U.S. money is of shorter maturity and is backed by the oil mechanism which we have.

Senator SARBANES. Is the other money backed by the oil mechanism?

Mr. SUMMERS. Lending of the World Bank, the IMF, and the IDB is not backed by the oil mechanism. It is backed by the international convention tradition, that loans to those institutions are serious obligations, that, except in the most extreme circumstances, countries have always met.

Senator SARBANES. In fact, those conditions are such that they usually are put first in line. But, here, even if that were the case, in terms of time, they come later, on the basis of the maturity.

Is that correct?

Mr. SUMMERS. That is certainly correct. Senator, there may be some overlap between the period of payments on the IMF 5-year money and the United States 3- to 5-year swaps so I don't want to leave you with the impression that all of the U.S. money would be paid back before the IMF received any payments, but it is true, in general terms, that our lending is in shorter terms, that's correct.

Senator SARBANES. Thank you very much, Mr. Chairman.

The CHAIRMAN. Mr. Summers, I'm going to read this little statement.

While I appreciate the argument made by former Secretary Bentsen that "you don't trigger a run on some other country's currency," I'm troubled, however, by the numerous statements made by the Administration clearly indicating its belief that the Mexican economy was sound, knowing all the while, however, that the economic policies which the Mexican government was pursuing would, in all

probability, lead to a meltdown of the Mexican economy in the very near future.

Secretary Bentsen concedes, realizing as early as August 1994, that the peso needed to be devalued. The Administration must have known that investors would catch on and that the Mexican strawhouse, so to speak, would eventually come tumbling down.

It is obvious, while one does not sabotage another country's economy by running around yelling that the world is falling down, that, by the same token, one does not put out false and misleading statements so as to obfuscate and cover those fears that, otherwise, the marketplace, in the ordinary course—and that information that people would be relying on, paper it over with the Administration's statements.

Now, the statement I read to you was not mine. It comes from a question that Senator Boxer asked to be placed in the record, but it leads in to that which I submitted to you on June 29, 1995, which is a chronology of the events.

I have to tell you they're very disturbing. Let me read you the next question that the Senator, after she makes her observations, asks, and I think it's quite correct:

> In the future, what steps will you take to avoid shading financial forecasts and to avoid misleading the American public?

There is a distinction and it's not even a fine line. It's easy. While you may not and should not undermine the stability of a neighbor, do you put out false and misleading statements?

I don't think you can or should or that it's excusable.

She goes on, as it relates to Mexico's economic stability or the economic stability of any other market. If we do it here, are we going to do it in other areas and then justify it by saying, "Well, we were concerned and that's why we put out the misleading statements"?

Have you looked at the chronology I sent as it relates to the various events?

Mr. SUMMERS. Yes, I have, Senator. Yes, I have.

The CHAIRMAN. I'm concerned that the Administration's public statements during that period of time don't square with the internal documents.

For example, on April 26, 1994, you sent Secretary Bentsen a memo in which you said:

> Mexico's dependency on the financing of its large current account deficits from largely volatile portfolio investments remains a serious problem.

And yet, on the same day, you told CNBC, and I quote:

> Mexico is fundamentally sound and has a fundamentally sound currency. We are very encouraged about the situation in Mexico.

Was that true? Were you really encouraged at that time?

Mr. SUMMERS. Senator, let me try to place that comment in context.

It's clear, in retrospect, that things went terribly, terribly wrong economically in Mexico and so——

The CHAIRMAN. You had just, that same date, called the problems to the attention of the Secretary. Yet, you said, "We are very encouraged about the situation in Mexico."

You see, it doesn't square. That's the issue Senator Boxer raised when she asked, "Do we do this kind of thing?"

What is the appropriate line? Do we go out of our way and then mislead our investors, mislead the financial community, when we say we are very encouraged about the situation.

Go ahead. I would like you to explain that.

Mr. SUMMERS. Senator, it is certainly wrong and was not and should never be our intent to try to mislead the investment community into doing anything on the basis of any false assurance that we would provide. That would simply be a crazy and wrong policy.

In late April, we were looking at a situation where Mexico had faced a tremendous shock from the Colosio assassination in late March, where the financial markets were extremely volatile because it was a period when the Fed was raising interest rates quite rapidly.

Mexico was in a very difficult situation where there was a lot of instability in late March and early April. They responded to that by allowing interest rates to increase substantially in an effort to bring about confidence, and in the near term, in that post-Colosio assassination period, while the environment was very volatile, things looked to be getting better.

At the end of that interview, that was what I was referring to when I said I was encouraged. It looked, at that time, like, if there weren't further serious shocks and Mexico pursued appropriate policies, things would move through.

As it turned out, the policies went wrong. There were more bad shocks and the situation unraveled.

The CHAIRMAN. Yes, but do you see the pattern? I spelled it out in a chronology. This was not one isolated situation—March, April, November. Even the President of the United States was making statements when internal documents indicate quite clearly that the situation had not improved from March to April.

You have to admit that the situation got much worse, didn't it?

Mr. SUMMERS. The Colosio assassination, which took place in late March, made the situation much worse.

The CHAIRMAN. April, it deteriorated. June, it deteriorated. July, it deteriorated. In August, it deteriorated.

It continued to deteriorate. Is that not true?

Mr. SUMMERS. The situation—the currency, macroeconomic situation, did deteriorate as the year went on and devaluation became more likely.

Senator, I think in understanding those statements it's important to realize that, in many, many of those statements, what was being addressed was the Mexican economy broadly, which has gone through tremendous changes. The largest part has been privatized. A lot of liberalization has made it a much more productive and free market economy than it had been. Those were real and important changes. It was those changes that were being pointed up in many of the statements. They certainly were not intended, nor should they have been taken, as guidance for particular investors investing in particular markets.

The CHAIRMAN. Mr. Summers, if you go through the report, the chronology, there is instance after instance of the same pattern; a pattern which demonstrates, on a factual basis, concern with the

deteriorating economy, the need, and, in some cases, the Mexican government requesting, that high Administration sources put out some strong words.

For example, Secretary Bentsen, in addition to yourself, coming forward on the same day you warned him that the situation was deteriorating, and that the President of the United States, 6 months after, long after the assassination, and when the situation had deteriorated to incredible proportions, contacted you, yourself, and raised the question of whether or not there should be a devaluation, and at what time we should do it.

Yet, the Administration informs the President and advises him that all is well, that this is the economic path we should follow, that it is a model.

Would you like me to quote you the exact words the President said, on December 8, 1994, at the Summit of the Americas? He calls it the model.

Now, it gets back not only to what I've raised, it gets back to Senator Boxer's position.

How do we do that? Don't we have an obligation to be square? If we're going to put out a report, shouldn't it be truthful?

I don't say we should necessarily say it's the worst situation we've seen and panic the markets, but when you see a situation deteriorating, to loan ourselves, to obfuscate the facts, to be less than truthful and, indeed, to be untruthful, isn't that wrong?

Secretary RUBIN. Senator, could I respond?

The CHAIRMAN. I would like to get a response from Mr. Summers on that.

Secretary RUBIN. You go ahead and I'll follow you.

The CHAIRMAN. Would you do that again?

Senator SARBANES. Mr. Chairman, I know there's five lights on for a vote. Are we going to come back here?

The CHAIRMAN. I'm ready to wrap this up, but I'd just like to know. I'd like to get down to this.

Secretary RUBIN. I really would like to say one thing, if I may, Mr. Chairman.

The CHAIRMAN. Would you do it again, Mr. Summers? Would you make that announcement, for example, given the same situation, the same circumstances?

Again, Senator Boxer asks, "What have we learned about this?" I'm paraphrasing now. "And what do we intend to do?"

Would we shape this or cover that kind of situation in the future?

Secretary RUBIN. Mr. Chairman, I have spent a fair part of my career involved in an organization that puts out enormous numbers of reports and evaluations on all sorts of companies and countries, for that matter, and I've looked at this and looked at this with great care.

I do not believe that there was any effort or intent to mislead.

The CHAIRMAN. Have you gone over the chronology, Mr. Secretary?

Secretary RUBIN. I have not gone over the document that you sent to Under Secretary Summers, no. But we have talked a lot about 1994 and the discussions that were held. There were many, many variables involved here.

I believe, when the President referred to Mexico as a model, he was right. I think there were enormous reforms in Mexico. I think they have created the basis for Mexico being prosperous again. I think, in many respects, it has been a model for developing countries around the world.

There was one problem, and the problem was the financial situation.

I have lived through a lot of those, Mr. Chairman. I think it was predictable that something had to happen. Either interest rates had to go up or there had to be a devaluation.

I think there was an extraordinarily low probability that you would have the kind of crisis that you did. I would guess that there was nobody, or virtually nobody who foresaw that there would be a crisis, as opposed to either higher interest rates or a devaluation.

I'm sorry. Larry?

Mr. SUMMERS. Senator, first of all, I would answer the question about what one's learned in terms of statements by saying that it's appropriate to make statements about the broad contours of economic policies and countries with which we interact.

I think, in retrospect, it would have been better if the statements had, much more clearly than they did, made clear that they were addressing the broad contours of economic reform in markets——

The CHAIRMAN. Mr. Summers?

Mr. SUMMERS. —and not allowed the interpretation that they were statements about the currency.

The CHAIRMAN. Professor Dornbusch and others had advised. You had memos. You knew. You had reports. You were aware of what was going on. It was a roulette game. Now, you were aware of that. You were concerned. I understand that.

Does that give one an excuse to put out a statement that is at variance with the fact?

You were really encouraged—you were panicked at the time. Yet, you put out these reports or had Secretary Bentsen, the President, and yourself make statements that were at variance with the facts.

If we want to, we can take the time to go through the chronology as to how many times we did this and when it happened.

The IMF released a report in December 1993, which concluded that:

> The enormity of capital inflows into Mexico raises the specter of several effects worrisome to policymakers, including rising current account deficits, excessive money growth, pressures on price and real exchange rates, and vulnerability to a sudden reversal of the inflows.

You were aware of those concerns, weren't you?

Mr. SUMMERS. Senator, I was aware that Mexico faced a difficult macroeconomic situation. I was also aware that Mexico had made profound changes in its economy, that it had strengthened its economic fundamentals, and had allowed inflation to come down.

The CHAIRMAN. At this period of time, we are talking about—we're not talking about the principles of moving into privatization. We're talking about, actually, what was taking place on the ground.

While people were being told of a rosy, wonderful picture, the situation was deteriorating.

You, yourself, have testified of the tremendous outflows of money. Isn't that true? The reserves, going from something in the area of $20 billion-plus to $6 billion.

Mr. SUMMERS. During the year, the Mexican reserve position did deteriorate and that was a matter of increasing concern.

The CHAIRMAN. The statements you were making covered that period of time. This wasn't abstract. While the very deterioration was taking place, while the IMF was sending signals, while others were sending strong signals to you, and the international currencies fell dramatically, Treasury was putting out glowing reports which were at variance with what you knew and what you knew was taking place.

Isn't that true?

Mr. SUMMERS. I think, Senator, the crucial distinction is the one that Secretary Rubin attempted to draw between statements about the Mexican economy generally, which had shown real improvement and had shown strengthening, increasing competitiveness, and more exports, and the situation in the currency markets which at that time didn't seem at all related to the possibility of default and meltdown that we've seen down the road.

The CHAIRMAN. Mr. Summers, I understand that, but let me say that the model has been a disaster. Only as a result of more than $20-plus billion being contributed by the United States and the IMF—and, by the way, don't we make a very substantial contribution to the IMF?

We account for about 30 percent of those dollars.

Mr. SUMMERS. I think our share in the IMF is actually just under 20 percent, Senator.

The CHAIRMAN. All right.

Secretary RUBIN. I don't know when we've last made a significant contribution, Mr. Chairman, but it's been a fair while. There was a small one, I think, 2 or 3 years ago.

Basically, that is an existing fund.

The CHAIRMAN. The point is we have rescued it, and we hope that we've rescued it, at least short-term, because we've stepped in and assumed the obligations of their short-term debt.

Now, that's what we've done. We've substituted the United States taxpayer in there for the Tesobono holder. We hope that, over a period of time, there will come some economic stability if, indeed, they adhere to the conditions laid down with respect to their economic policies and their financial undertakings.

We hope it happens. I hope it happens.

I have to tell you, I don't think it's right for any Administration to be saying anything that they know is at variance with the facts. It's wrong. Indeed, it may have precipitated some in making investments into these areas that they otherwise would not have made if you had not painted a rosy picture.

When people in the Administration are saying all is well and they have been working closely, given the NAFTA, given GATT, given the privatization efforts, and given the previous Administration's efforts to paint this rosy, glowing picture, but, now, when we look at it, it seems a lot of it was just inaccurate. We took for granted the fact that well-educated men in high places, men who had gone to the finest of schools and gotten their MBA's, that,

somehow, this was a guarantee, because I was told this. I was told this by the previous Administration, that all's well. This is remarkable.

We had pumped up this situation. Sometimes, I think we get to a point where we're afraid to admit what the facts are because they change so dramatically when we begin to learn the truth that we're shocked.

In any event, I would hope—and I just leave you with this thought because I was raising my eyebrows at a point when the question was raised by Senator Sarbanes as it relates to what commitments have we made.

As a practical matter, we are committed to send the $7½ billion down if it meets the three conditions. To begin to split hairs and say, "Well, we're not committed," I read, in the practical sense, that we are very much committed and that, indeed, if the various things that you've outlined, the three essential points, are met, that we will be drawing down on those dollars.

If I were to ask you, what is the likelihood that we would not be drawing down—would you like me to pose the question that way? I will.

What is the likelihood that we will not call and draw down on any more of the funds?

Secretary RUBIN. Mr. Chairman, I think we're going to have to make a practical judgment as we go along. It is certainly our hope that we will not be sending all of that money and it's not absolutely clear that we'll be sending any additional money.

I think we'll make a practical judgment in the context of the then-conditions.

The CHAIRMAN. All right.

Secretary RUBIN. Just so there's no misunderstanding.

The CHAIRMAN. All right.

Secretary RUBIN. Let me say, the money is available if the conditions are met. We will have to make a practical judgment in our sole discretion with regard to the criteria.

The CHAIRMAN. If you were to say, do you really anticipate there being a chance that you wouldn't draw down on any more of the $7½ billion?

Secretary RUBIN. I think that is at least a realistic possibility, yes, Mr. Chairman.

The CHAIRMAN. You think it's a realistic possibility?

Secretary RUBIN. Yes, I do.

The CHAIRMAN. Mr. Secretary, I hope it is true. I honestly do.

Secretary RUBIN. But I want to be very careful so there's no misunderstanding. There's also a realistic possibility that we will draw down. The answer is we do not know and we'll know as time goes on.

The CHAIRMAN. You're spending too much time with Alan Greenspan.

[Laughter.]

You give one answer and we think we have it, then, but I want to—and some great law school professor will come in and give you one side, then destroy it just before they leave.

In other words, there's a good possibility that we may not draw down upon it, but there is a good possibility that we may draw down upon it.

Secretary RUBIN. I think we agree with your analysis.

[Laughter.]

The CHAIRMAN. On that note, Mr. Secretary, I want to reiterate. We may have differences as it relates to the policy of the redeeming of the Tesobonos. We do. We disagree on that.

But there is no disagreement with my analysis and that proffered by Senator Faircloth. I want to thank you for your stewardship, for your work, and for your public service.

There is no disagreement as it relates to that.

Similarly, Mr. Summers, I want to convey to you our appreciation for making yourself available and for coming through this process. It's not an easy one, certainly.

We thank you, and we stand in recess.

Secretary RUBIN. Thank you, Mr. Chairman.

Mr. SUMMERS. Thank you.

[Whereupon, at 12:45 p.m., the Committee was adjourned.]

[Prepared statements and additional material supplied for the record follow:]

PREPARED STATEMENT OF ROBERT E. RUBIN

SECRETARY, U.S. DEPARTMENT OF THE TREASURY, WASHINGTON, DC

JULY 14, 1995

Mr. Chairman and Members of the Committee, thank you for the invitation to speak with you this morning about the U.S. program to support Mexico's stabilization.

Since I testified on Mexico before this Committee on March 10, Mexico's stabilization program has gained very significant ground. While Mexico continues to face substantial challenges, I am greatly encouraged by progress achieved to date. The goal of promoting U.S. exports, jobs, and the security of our borders over the long run is being accomplished. Potential spill-over into other emerging markets that are so important to U.S. security and economic interests has been contained.

The U.S.-led international support program has been essential to Mexico's success so far. Our funds, along with financial support from the international community via the IMF, the Inter-American Development Bank, and the World Bank, have supported Mexico in implementing the policies needed to put its economy back on the track toward growth and prosperity.

As you know, on July 5, 1995, the Treasury provided $2.5 billion in support to Mexico. That brought total outstanding funding by the United States under the February 21, 1995 agreements to $12.5 billion, including $1 billion from the Federal Reserve. I have been asked why, if Mexico is making substantial progress, we provided this latest disbursement. This is an important question which both Under Secretary Summers and I will address today. Before we do so, however, I want to review the reasons why the President authorized the program and why it is so important to persevere.

U.S. Interests

On January 31, 1995, with bipartisan support of the congressional leadership and of the Federal Reserve Board, the President acted to safeguard important U.S. interests by authorizing up to $20 billion in support to Mexico through Treasury's Exchange Stabilization Fund, or ESF. Potential escalation of the crisis in Mexico was a direct, long-term threat to U.S. exports and jobs that depend on bilateral trade. At the same time, the crisis put at risk the security of our 2,000-mile border with Mexico.

Mexico's difficulties threatened to spread beyond its borders to other promising emerging markets. That could have had a chilling effect on the important market reforms that these countries have been advancing, and which we have been advocating for decades. Our leadership was central to protecting our interests and to marshaling international support—specifically, $18.9 billion in emergency support from the IMF.

On February 21, 1995, I signed four agreements to implement the plan. These agreements were based on one overriding principle: The need to protect U.S. interests. They contain rigorous economic, financial, and reporting requirements to ensure that all U.S. resources committed in this program are secure. Funding to Mexico has been provided in stages and, before each new disbursement, we have verified that Mexico continues to meet these strict conditions.

The agreements provide assured backing for our support from Mexico's oil export proceeds. Given the importance of the oil backing, we formed an interagency working group to analyze Mexico's oil export prospects over the long term. The group's conclusions confirm that Mexico's oil export revenues will fully back all outstanding disbursements and potential disbursements under the program.

Returning Confidence

When I first appeared before this Committee 4 months ago to describe our support effort, it was far too soon to make anything but the most preliminary judgment about the probability of success, though it was certainly our view that this plan should work. Today, the signs of success are substantial. Mexico's government has demonstrated a steadfast determination to meet its commitments, and take the steps necessary to restore financial stability. Market confidence has begun to return, and capital inflows to Mexico have resumed. Mexico's money supply, on an inflation-adjusted basis, has declined by 38 percent this year. Mexico has moved to a fiscal surplus, and to a trade surplus. The outstanding stock of Tesobonos, which were at the heart of the Mexican crisis, have been reduced from $29.2 billion at the beginning of the year to $8.9 billion today. More than $2 billion in dollar borrowings from the bank insurance fund have been repaid.

The crisis of confidence which Mexico's situation created in other emerging markets has subsided. Mexico is regaining access to international capital markets faster

than expected. Just this week, the government returned to the international markets with a highly successful bond issue. The success and expansion of such efforts are essential for continued stability and a return to growth.

Political Reforms

While our assistance program is not conditioned on political and judicial reforms, its support of economic stabilization has increased the prospects for their success. Since taking office, President Zedillo has moved to weed out corruption and has taken steps to continue reform of Mexico's judicial and electoral systems. The fact that opposition candidates have won recent electoral victories is an encouraging sign that the democratization process is deepening.

Cooperation to Halt Narcotic Trafficking

Mexico is making progress on other fronts. United States–Mexican cooperation in combating illicit drug trafficking has improved markedly. Attorney General Reno has held repeated talks with Mexican Attorney General Lozano since the day of President Zedillo's inauguration. The two have established a new, intensive coordination mechanism at the senior policy level. The Justice Department informs me that Mexico's resolve has begun to bear fruit, such as the arrest 3 weeks ago of Hector Salazar, a powerful Mexican drug leader, the capture of Jose Sosa-Mayorga, an important criminal kingpin, in late May, and the April seizure of a record $6.35 million in cash at Mexico City's airport.

Attorney General Lozano intends to push a tough penal code reform package through the Mexican legislature this autumn. That will greatly enhance Mexican investigative procedures. We expect our joint efforts to progress further in the months ahead. Obviously, much more needs to be done, and we will continue to push forward with the Mexicans to combat the narcotics problem.

Lessons for the International Financial Community

The international financial community has also learned much from Mexico's experience. In this age of faster and more integrated capital markets, we must improve our tools for preventing crises before they happen, and enhance international capacity to deal quickly with crises that do unfold, before they spread to other parts of the global financial system. That is why the G–7 countries support a range of measures designed to increase transparency and surveillance, and expand emergency financing capabilities through the IMF's General Agreement to Borrow. These steps will adapt the financial system to present needs, without cost to the U.S. budget.

Latest Disbursement—Promoting Stability

Clearly, Mexico has come a long way in a short time. With a strong trade performance, sound financial policies, and continued structural reform, growth should return by 1996. Our decision to disburse $2.5 billion last week supports continued Mexican progress and U.S. interest in solidifying the prospects for Mexico's success.

U.S. Support in the Second Half

In the press release for the Mexican support program, issued when we signed our agreements with Mexico, I stated that "Ten billion dollars will be made available in stages between now and the end of June 1995 . . . [and] using the same terms and conditions, another $10 billion will become available—as needed and in stages—beginning in July." Staging our funding has provided us with the capacity to assess Mexico's financing needs on an ongoing basis.

As noted in the letter which you and Senator Dole recently wrote to me, Mr. Chairman, Mexico indicated on February 21, 1995, that the second $10 billion would be available for "unforeseen contingencies." It was our hope—clearly shared by Congress—that it would not be necessary to utilize the second $10 billion of the $20 billion support package. We regret any incorrect impression we might have left that the second $10 billion would be available only for an emergency. Both Under Secretary Summers and I, in response to Members' questions, made it clear that solid evidence that the stabilization program was working would be a necessary condition for any disbursement beyond the first half-year's $10 billion.

Our decision to disburse $2.5 billion last week reflects our belief that the program is working, and is not a sign that Mexico is faltering. Data on capital flows continuously becomes available that informs our assessment of Mexico's financing needs. In view of the heavy amortization schedule this summer, our desire to promote the rising tide of market sentiment, and our current forecasts for net inflows of funds from all sources in the third quarter, we decided that it would be prudent to disburse these funds.

Conclusion

Mr. Chairman, I think the best way to understand why the United States-led effort is so important is to put Mexico's present difficulties in historic perspective. The current crisis has been compared to Mexico's debt crisis of 13 years ago. That crisis spawned economic calamity, first in Mexico, then, a few months later in Brazil, and, finally, throughout Latin America. It led to what has been called a "lost decade" of protectionist policies, negative growth, financial instability, and political and social unrest in much of this hemisphere.

Here at home, Mexico's and Latin America's difficulties in 1982 posed a serious challenge to the health of our financial system. They sent the number of illegal immigrants crossing into the United States sharply higher. Ultimately, Mexico and Latin America's collapse deprived our economy of a full decade's worth of opportunities for trade and investment in some of the largest markets available to us.

Mexico's economy is not what it was in 1982. After 7 years of reform, the pieces are in place for Mexico to avoid a repetition of the lost decade and, instead, to achieve a healthy rate of economic growth. It was to avert another lost decade and all the harm it caused us that the United States chose to lead the present support effort for Mexico. We are now on the path toward success.

The 1982 crisis prompted a severe wage-price spiral. Prices soared by 42 percent over the first 6 months of the crisis, and inflation continued to rise unchecked, hitting 110 percent between January 1982 and January 1983. Today, the situation looks very different. Though prices have risen over the first 6 months, inflation is now falling, thanks to strong action by the Mexican government.

In 1982, Mexico's currency continued to depreciate sharply, by a full 73 percent between January 1982 and January 1983. This time, the decline in the peso appears to have halted after an initial 55 percent fall. In fact, the peso has strengthened by 23 percent since March, even while Mexican reserves are rising.

Mexico's current account deficit is adjusting more quickly than it did 13 years ago. The deficit narrowed sharply from 7.7 percent of GDP in the last quarter of last year to 2.1 percent over this year's first quarter—compared to 7.3 percent in the first quarter of 1982, and 5.3 percent in the second quarter. Rising trade surpluses in April and May of this year suggest that adjustment will continue. This time it has taken Mexico's government only 7 months to regain access to international capital markets. In 1982, Mexico was shut out of world markets for a full 7 years.

Most importantly, in 1982, Mexico and other Latin American countries initially responded to difficulties by retreating from the kind of free market measures we have sought to promote for decades. The Mexican government slapped on exchange controls, raised import restrictions, nationalized the banking system, suspended debt repayments, and generally retreated behind protectionist walls.

The outlook is very different in 1995. This time Mexico's difficulties have prompted the government to accelerate privatization, and to free up wage bargaining and other sectors of the economy more quickly. The Mexicans are moving swiftly to shore up their financial, regulatory, and legal environments, while lifting restrictions on foreign investment. Most important from a U.S. perspective, the Mexicans have chosen to keep their markets open. This embrace of the market offers Mexico and the United States our best chance for escaping another lost decade.

Under Secretary Summers will now describe in greater detail the changes we have seen in Mexico's economy over the past 6 months. Thank you.

PREPARED STATEMENT OF LAWRENCE H. SUMMERS

UNDER SECRETARY OF THE TREASURY FOR INTERNATIONAL AFFAIRS, WASHINGTON, DC

JULY 14, 1995

Mr. Chairman and Members of the Committee, thank you for the opportunity to meet with you this morning to discuss the U.S. support program for Mexico. I would like to describe Mexico's economic stabilization efforts and provide more detailed information regarding our decision to disburse $2.5 billion to Mexico last week.

Implementation of the Economic Stabilization Program

When Secretary Rubin and I testified to this Committee in March, it was clear that a fundamental change in the course of Mexico's policies was required. Mexico has needed to correct the errors of 1994 that threatened its financial stability and long-term prospects for growth. It is now going through a painful and difficult adjustment process, but I can report to you that Mexico's commitment to policy reform

has resulted in significant progress, and our objectives in supporting Mexico's adjustment are being served.

Mexico's money supply is down 17 percent since the beginning of the year. The budget surplus has exceeded expectations, rising to 2.7 percent of GDP in the first quarter. Mexico is preparing transportation and petrochemical operations for sale and is opening the telecommunications and gas sectors to private investment. The central bank has increased the frequency and breadth of its public reporting, now publishing information on money market operations daily and key balance sheet data weekly. The bank will soon make this information available via the Internet.

Progress to Date

The results of the economic stabilization program have been promising. Inflation is down to 3 percent in June, from its 8 percent peak in April, and is expected to decline further in the second half of the year. Strong export growth and restrained imports have reversed Mexico's trade imbalance much faster than expected. Mexico is also managing its dollar debt crisis successfully. Over two-thirds of the $30 billion in Tesobonos have been repaid since the beginning of the year. With international support, Mexico has raised external reserves to over $14 billion, up from $6 billion at the beginning of the year, despite large repayments of debt.

Returning Confidence

The financial markets have responded to the strong policies and the economic adjustments they are witnessing in Mexico. The peso has strengthened over 20 percent since March and stabilized. Peso forward rates for the end of the year have risen almost 40 percent from their mid-March lows. Mexican stocks and prices on Mexican Brady bonds have recovered to pre-crisis levels. Mexican government agencies and some banks are regaining access to private sources of capital. And, earlier this week, the government made a strong return to international capital markets. A $500 million offering by the government was raised to $1 billion when demand exceeded the original supply by three times.

At the same time, capital flows have resumed with strength to many other developing countries. The rally in Brady bond markets in general suggests the risk of contagion from the Mexican crisis has diminished significantly.

Outstanding Problems

Inevitably, given the magnitude of the adjustment necessary, Mexico's economy has entered a deep recession. Unemployment has risen sharply. However, most observers now expect a resumption of growth late this year or early next year. Indeed, recent reports on the performance by Mexican businesses during the second quarter were more favorable than most analysts expected. As Secretary Rubin pointed out in his testimony, the adjustment will be less painful and protracted than that which followed the 1982 crisis.

As the recession has deepened, working Mexicans have faced growing sacrifices. Mexico's government has worked to mitigate the impact of the crisis, particularly on the poor. These efforts are backed by $1 billion in World Bank and IDB lending. Social cohesion has been maintained despite the difficult economic circumstances.

On June 1, 1995, the Mexican government presented a long-term development plan that stresses the importance of long-term savings and investment in human resources, including basic education, health services, and nutrition.

In our testimony and reports to Congress, we have consistently highlighted the Mexican banking system as a crucial issue. Mexico's recession and high interest rates have left many borrowers unable to repay their loans. The Mexican government has responded to banking problems with measures to improve regulation and supervision of banks, to encourage new investment in the financial sector, and to close insolvent institutions, without the creation of excess liquidity. We are monitoring the situation closely.

There have recently been some encouraging developments with respect to this sector. Interest rates have fallen from over 80 percent to nearly 40 percent. The banks have been able to repay $2.3 billion of the $3.8 billion borrowed from the government's insurance fund. The government will receive $1.75 billion in World Bank and Inter-American Development Bank loans, which are conditioned on stronger regulatory controls and improved accounting standards. Removal of certain limitations under the NAFTA on foreign acquisitions of Mexican banks, as well as recent government efforts to encourage and support bank restructuring, have facilitated bank recapitalization. Already, one foreign investor has recapitalized and assumed control of a Mexican institution. Several other deals are under discussion.

Treasury is monitoring banking problems and the broader economy closely. We have implemented systems for the regular collection of some 60 categories of information embracing nearly 250 pieces of data from the Mexican government. Treasury

staff are in daily contact with Mexican officials and will complete five compliance missions to Mexico in July alone.

U.S. Support in the Second Half

With our assistance, Mexico has come a long way. Our decision to disburse $2.5 billion earlier this month recognized this progress. It also recognized the U.S. interest in solidifying the prospects for Mexico's success and its rapid return to growth. Our disbursement reduced the uncertainty surrounding the need for Mexico to repay almost $7 billion of Tesobonos over the next several weeks. The continued strengthening of confidence and stability will encourage the private sector inflows that are necessary for the program to succeed. It is also the way for Mexico to reduce its reliance on official external support.

Our disbursement coincided with that of the IMF, which, under its $18.9 billion standby arrangement, announced on June 30, 1995, the immediate release of $2 billion, adding to the $7.8 billion disbursed in February. The IMF also announced that it would make available $8.7 billion in five tranches over the next year, including $1.73 billion in August, subject to Mexico's continued satisfactory performance. I would also note that World Bank and IDB funding approved in June will add $2.8 billion to Mexico's external resources.

Let me just say on the question of the last disbursement, I sincerely regret any incorrect impression we left in our discussions regarding the availability of the second $10 billion of U.S. support. It was our intention to provide all of our support on a staged and conditional basis if and when it was needed. For the reasons I just referred to, it was our decision to provide $2.5 billion in early July.

Conclusion

Mexico has advanced substantially on the path to recovery. The U.S.-led international support program fortified Mexico's commitment to right the policy errors of 1994 and to adhere to a disciplined program based upon the fundamentals of sound economic management.

I believe that history will demonstrate that the President's decision to support Mexico was the right one—for security along our borders and in our hemisphere, for our economic security world-wide, and for American jobs. Thank you.

QUESTIONS FOR SECRETARY RUBIN AND FOR UNDER SECRETARY SUMMERS REGARDING THE MEXICO LOAN GUARANTEES FROM SENATOR BARBARA BOXER

Q.1. Mexican President Zedillo recently conceded that the Mexican economic crisis was not over, he went on to state that average Mexicans are "living through the most difficult moments of unemployment. . . ." An independent analyst stated that the U.S. support package hasn't "trickled down . . . but it wasn't supposed to do that, it was not supposed to solve the crisis." Based on these statements and numerous similar statements which have been widely reported, it seems clear that the U.S. support package has not helped the millions of Mexicans who have lost their jobs or helped to curb inflation rates which are projected to exceed 50 percent this year. So my question to you is what measures, if any, are in place to help solve Mexico's more long-term economic problems because it appears that expenditures from U.S. funds have helped only wealthy bondholders and large corporate investors. It seems to me that in order to really help Mexico, and avert another crisis, their underlying economic policies need to be dealt with—not just their short-term liquidity problems.

Q.2. Since the Tesobonos investors were large sophisticated emerging market investors why shouldn't they bear the brunt of the inherent risk? These investors spend millions of dollars and countless hours analyzing the Mexican market. They are also well aware that emerging markets are typically illiquid, risky, and thinly capitalized. Yet, for whatever reasons, perhaps chasing high yields, these investors ignored or failed to carefully examine the data available to them indicating that Mexico had promised to pay back more dollars than it had in reserve.

Q.3. In the future, what steps will you take to avoid shading financial forecasts as they relate to the economic stability of emerging or other markets?

Q.4. What measures were discussed by the G–7 in Halifax which could be undertaken to help prevent economic calamities similar to the one which occurred in Mexico? In the future, when such calamities do occur, what kinds of international resources (either through the General Agreements to Borrow, an international bankruptcy fund, or some other mechanism) can be made available so that the U.S. taxpayers are not looked to, once again, as the lender of last resort?

I am particularly interested in Mr. Summer's response to this question since he has stated, and I agree, that "some of the principle threats we face are no longer to our military security but to our economic security."

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